

# Winning Stock & Option Strategies

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Generate Cashflow & Protect Profits  
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Profit in Every Market Trend

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# **WINNING STOCK & OPTION STRATEGIES**

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## **APPENDIX A – STOCK MARKET ESSENTIALS**

## CHAPTER 1 – INTRODUCTION

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The *dot.com* phenomenon in the late nineties demonstrated the ease with which money can be made in a rising market. But as the aftermath of that phenomenon demonstrated there is a flip side to that coin. Paper profits can be wiped out and major losses incurred in the seeming blink of an eye.

Many people have concluded from their experiences during the market downturn that stock market investing is very fickle, that there is a large element of luck in trading, that one must buy and sell at the right times, and that making the necessary decisions is often fraught with angst. These uncertainties have made them fearful of the stock market and at the same time they have a desire to play the market with a view to enhancing their own financial positions.

This mix of emotions, the desire to participate allied with the fear of incurring losses, is frequently compounded by misconceptions about stock markets. Many people, for example, would take it as given that money can only be made if stock prices rise. But believe it or not, that would be incorrect! What would you say if you were told that there was a way to protect what you had invested? What if you were told that you could protect the stocks that you had invested your life savings in? Would you be interested in learning how to protect your money no matter how the stock performed, even if the stock price *fell*?

What if you were told that you could generate money every month on stocks you already own? You would not have to wait passively for stock prices to rise but you could proactively generate cash each and every month. Would you be interested in learning how to do that?

The overall objective of this book is to explain how one can profit in the market regardless of the direction in which it moves, and how to do so with equanimity and a high sense of personal control. This book provides you with the necessary tools to be able to achieve this goal through the strategies of spread trading. This knowledge, combined with an understanding of techniques and strategies for analyzing stocks with a view to determining their likely direction of future movement, should enable you to trade profitably and consistently in any market. These matters and all related matters are covered in detail in this book, as are suggestions as to precisely how one should move from a mastery of the skills involved to profitable market place trading.

The strategies proposed have been thoroughly tested and disciplined adherence to them should provide you with ***Winning Stock & Option Strategies***. They should yield handsome and consistent profits over time coupled with tremendous personal satisfaction.



# CHAPTER 1 – INTRODUCTION

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## 1.1 Objectives

When you have completed this book you should have an excellent understanding of the following topics:

- **How to answer the *million dollar* question – how can I buy high, sell low and profit?**
- **What stocks to buy and *when* to buy them**
- **When to trade with the crowd and when to trade against the crowd**
- ***Eliminate greed* in your trading**
- **How to own a stock for zero cost basis**
- **Proactively generate cash flow with stocks you own**
- ***Eliminate fear* in your trading**
- **How to insure your stocks when the market goes down**
- **How to profit in a down trending market**
- **How to profit using advanced strategies**
- **What exit strategies to use**
- **How to correctly apply strategies**
- **What brokerage should you use**
- **Money management**

## 1.2 What is the profit potential and how can I achieve it?

In order to gain maximum benefit from this book you should plan on putting in the effort to get a good understanding of the principles involved and you should paper trade for a further period. It is also recommended that you refrain from real-life trading until such time as your command of the subject is producing 7 or 8 successful trades out of every 10.

Application of the strategies taught in this book could yield annual returns of 40% for low-medium risk strategies and much more if higher risk strategies are employed! Thus an initial investment of \$5,000 is capable of being turned into \$27,000 over five years, and into \$144,000 over ten years. Indeed if the annual rate of return could be lifted to 50% and the term extended to fifteen years, the original \$5,000 would appreciate to well in excess of \$2,000,000! So the potential is fantastic!

In this book you will learn that, in many cases, you do not have to accept losses. In fact when you learn to adjust your trade to the current trend you can often turn a losing trade into a profitable trade. You will learn that you can protect your money such that even if the stock you purchased goes to zero, you can still sell the stock at a fixed price and hence limit your risk. You will also learn strategies that will allow you execute a trade and be confident that even if you don't look at the stock market for the next year you will not have to worry about the outcome of the trade.

# CHAPTER 1 – INTRODUCTION

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## 1.3 *Trading Psychology*

It is further the intention of this book to eliminate *limiting beliefs* such as:

- **You have to accept losses**
- **You can lose all your money**
- **Trading is risky and complicated**
- **You have to dedicate a huge amount of time to be successful**
- **The trade must go your way**
- **You have to be very intelligent to trade**

And to replace them with *empowering beliefs*:

- **Trading can be low risk**
- **Trading with pre-defined exit points will reduce fear**
- **Trading can be simple**
- **Trading does not have to demand a huge amount of time**
- **You can be consistently profitable when trading**

## CHAPTER 2 – OPTIONS BASICS

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### 2.1 *Introduction to options*

In spite of increased access and awareness of the workings of the options market, many diametrically opposed myths exist regarding options. Options were in fact created as a means for hedging risk or protecting *long* and *short* (Appendix A) positions in the market place.

They are not as some contend a much riskier investment than stocks. This is not to say there are no risks involved in options trading or the risks cannot be substantial if they are mis-used. This can also be argued of stock investments. Those who invested in Enron during the “bubble” period of 2000 without protecting their investment through purchase of put options stood to lose their entire investment. The protection afforded by the option purchase would have afforded them the right to sell their stock for a particular price even if the stock was worth zero. This will be explained later but the concept is worth understanding now.

Another viewpoint on options is that they are a license to print money. Although options can generate substantial gains exceeding 100% and sometimes even 1000% in a small time frame, they can also expire worthless after a set time frame at which point their entire value is worthless. Correct application of when to hold options, when to allow them expire or when to exercise them will be covered in detail later.

### 2.2 *What is an option?*

An option is a legally binding contract between a buyer and a seller.

The contract gives the buyer the ***right*** to buy or sell the stock at a specific price called the strike price on or before a specific date called the expiration date.

The seller is ***obligated*** to sell or buy the stock at a specific price (strike price) once the option buyer exercises his/her option.

The option buyer can choose to exercise his/her option anytime prior to expiration date. The option seller must fulfill the terms of the contract if the option buyer chooses to exercise.

### 2.3 *What types of options exist?*

Two options trading tools exist

1. **Call Option**
2. **Put Option**

## CHAPTER 2 – OPTIONS BASICS

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→The *call* option gives the options *buyer* the *right to buy* the stock at a fixed price within a set time frame.

→The *call* option *seller* or writer is *obligated to sell* the stock at a fixed price within a set time frame. This is covered in more detail in the next chapter.

→The *put* option gives the options *buyer* the *right to sell* the stock at a fixed price within a set time frame.

→The *put* option *seller* is *obligated to buy* the stock at a fixed price within a set time frame. This will also be examined further in the next chapter.

### How are options purchased?

Unlike stock that can be purchased on a per share basis, options are purchased in contracts.

1 contract = 100 shares of a stock

### 2.4 Why would I use options?

A number of powerful reasons exist to use options as a trading instrument. When using options you can:

- **Leverage capital**
- **Reduce risk**
- **Control stock without owning it**
- **Generate increased return on investment**

Options can earn significant percentage returns with reduced capital risk and reduced movement in the underlying stock.

In order to show how large amounts of stock can be controlled for a lot less capital using options let's consider the following example using call options versus stock purchasing.

#### Example:

If Microsoft was trading at \$30/share and I wanted to buy 1000 shares, the cost basis would be  $1000 \times \$30 = \$30,000$ . In order to double my money Microsoft must now reach \$60/share.

But what would happen if Microsoft instead fell in value to \$20/share? My \$30,000 investment would now be worth \$20,000 so I would have lost \$10,000.

As mentioned above 1 option contract equates to 100 shares of stock. So now let's consider what would happen if 10 contracts equating to 1000 shares of Microsoft were purchased at a strike price of \$30. The per share cost of the option was \$5. So this

## CHAPTER 2 – OPTIONS BASICS

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means I have paid \$5 per share or \$500 per contract and since I have 10 contracts I have paid \$5000 which gives me the right to buy Microsoft stock at \$30. Now if Microsoft trades up to \$40 per share my call options will be worth \$10/share (\$40-\$30) or \$1000/contract or \$10,000 for 10 contracts. So as the stock moved from \$30 to \$40 within the set time frame my options investment has increased 100% even though the stock only increased 33%. And if the stock dropped to \$20 I would have lost only \$5,000 rather than \$10,000 in the case where I only bought the stock.

So using proper money management the probability of making money can greatly increase using options.

This example has shown all the advantages of options.

Leverage Capital: A \$5,000 options purchase was shown to control as many shares as a \$30,000 stock purchase

Reduce Risk: For the same decrease in stock price from \$30/share to \$20/share the purchaser of stocks lost \$10,000 while the purchaser of options lost \$5,000

Control Stock Without Owning It: In this example the buyer of the call option could sell the option when the stock rose from \$30/share to \$40/share without ever owning the stock.

Increased Return on Investment: For the same increase in stock price from \$30/share to \$40/share the percentage investment increase for the stock buyer was 33% while the options buyer had a 100% increase in investment

### 2.5 *Summary*

Options leverage capital, reduce risk, allow stock control without ownership and facilitate increased return on investment.

In order to learn how to adjust your trades to the current trend to maintain profits you will need a good understanding of options trading instruments and terminology.

## CHAPTER 3 – SPREAD TRADING OVERVIEW

### 3.1 *Introduction to Spread Trading*

This chapter provides an insight into the benefits of spread trading versus directional trading.

### 3.2 *Spread Trading Overview*

Many individual investors in the market are directional traders. In general this means they buy a stock or mutual fund with the expectation that the value of the stock or mutual fund will rise over time. Directional trading is risky because the balance of forces which determine the value of a stock at any point in time is arguably as likely to push it in one direction as the other. If you buy a stock at \$10 and it loses 10% of its value you now own the stock for \$9. The stock must now increase by \$1 or 11% for you to break even. Now what if the stock dropped \$2, you have lost 20% of your investment. The stock must now rise from \$8 to \$10 or 25% before you break even. And if you lost \$5 or 50% of your investment the stock would now need to double from \$5 to \$10 before you are at breakeven, so you need a 100% gain!

This course shows you how to profit through spread trading.

**Spread trading is the practice of purchasing one option contract and the simultaneous sale of a related option, such as two options of the same class (calls/puts) but different strike prices and/or expiration dates.**

Spread trading is used by futures and options traders to reduce the risk of losing large sums from a sudden movement in the market.

Spread trading can yield annual returns of 20% or 30% with minimal risk and sometimes no risk. Annual returns exceeding 100% or much more are possible by increasing your risk tolerance but still exposing yourself to significantly less risk than is incurred through directional trading. So why doesn't everyone spread trade? And why don't they use options? A pervasive belief exists that options are risky. Firstly, it should be noted that options were introduced as a means of effectively managing risk. Correct application of options in the form of various strategies that comprise spread trading enables individuals' trade in a systematic manner with reduced risk. Provided an individual understands options trading instruments (and completion of this book will provide that understanding) there is no reason to consider options risky because at all times the risks and rewards of any given trade are known.

In summary, knowledge of options trading instruments reduces risk in options trading. This course will provide you with that knowledge.

So let us compare the risks associated with options trading and stock trading in a simple example.

## CHAPTER 3 – SPREAD TRADING OVERVIEW

### Stock Example:

So let us say stock ABC is trading at \$10 per share and I want to buy 100 shares of the stock. The price I will have to pay is my cost basis.

$$\text{Stock Cost Basis} = 100 \times \$10 = \$1000$$

### Options Example:

Options are typically bought in contracts where a contract consists of 100 shares of stock. Now if I were to buy one option contract consisting of 100 shares at a strike price (this term will be explained later) of \$10, the purchase price may typically be \$1.50 per share.

$$\text{Option Cost Basis} = 100 \text{ shares} \times \$1.50 / \text{share} = \$150$$

So, in order to control 100 shares of the stock through a stock purchase I need to spend \$1000 whereas I can control the same number of shares with an option for a fraction of the capital, only \$150. So, with stocks I must risk \$1000 but with options I only risk a fraction of that capital and still maintain the same control.

Buying stock is considered directional trading because you only make money on your investment if the stock goes in one direction – up! As will be made clear on the following pages, spread trading enables you to make money when the market moves in any direction whether up, down or even stagnant.

Options terminology will be explained later. It is not necessary to understand the nuances at this point, just the overall concept.

### 3.3 *Directional Trading Vs. Spread Trading*

| Directional Trading            |                                                           |
|--------------------------------|-----------------------------------------------------------|
| Advantages                     | Disadvantages                                             |
| Higher profit potential        | Higher loss potential                                     |
| Gain from short-term movements | Must guess direction correctly to profit                  |
|                                | Higher risk since profit is only one direction            |
|                                | Requires larger capital investment                        |
|                                | Price fluctuation will impact investment to larger extent |

## CHAPTER 3 – SPREAD TRADING OVERVIEW

| Spread Trading                                            |                                |
|-----------------------------------------------------------|--------------------------------|
| Advantages                                                | Disadvantages                  |
| Can profit when market trending up, down or even stagnant | Longer time to realize profits |
| Smaller capital investment required                       | Reduced profit potential       |
| Ability to adjust trades                                  |                                |
| Less susceptible to price fluctuations                    |                                |

### 3.4 *Greed and Fear*

Supply and demand will affect changes in stock prices. As stock prices rise, greed will dominate the market place buyers and, when prices fall, fear dominates the mindset of sellers.

One critical key to success is the ability to trade objectively by eliminating both greed and fear and the method for achieving this will be outlined later. It is important to realize at this stage that this is one of our primary objectives.



## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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### ***4.1 Introduction***

In this section the options trading instruments will be covered in addition to an explanation of options terminology.

### ***4.2 The Long & Short Of Stocks***

Often you will hear market commentators pass remarks such as “Investor ABC is long the stock” or “The sentiment is bearish and investor XYZ is shorting this stock”. So what do the terms long and short mean?

The first thing to note is that the terms long and short have no reference to time. When you are long a stock it means you have bought stock to open a position. For many this is the only form of trading they are aware of. It is the widely practiced method of buying a stock with the expectation of the stock value rising over time. It is therefore a debit trade.

It is equally possible to short stocks. This means you are selling to open a position. In the case of stocks you are expecting the stock you shorted or sold to decrease in value such that you can buy it back at a lower cost. It is a credit trade.

As an example consider you believed based on your fundamental, technical and sentimental analysis that a stock was going to decrease in value and you wanted to profit from the downtrend you could sell the stock without ever having owned it. Let's say the stock was trading at \$20/share and you sold/shorted 100 shares, your account would now get credited \$2,000. If the stock now decreased in value to \$15 you could buy back the stock at \$15/share x 100 shares or \$1,500 and profit \$500.

This can be a risky strategy and will not be covered in this book. The reason is that in theory your risk is unlimited if you short stocks. Theoretically there is no limit to how high the stock can rise so in the example above if the stock did not move as predicted but in fact jumped to \$30 based on some unexpected news event then you would have sold the stock at \$20/share but you would have to buy it back at \$30/share so you would lose \$10/share x 100 shares or \$1000.

Long and short positions can be applied to options and in this case short positions can be used very effectively to reduce your cost basis on trades and can be used safely as will be shown in the strategies outlined. The credit received from your short options' positions can help you cash flow money every month and significantly increase your portfolio value without accepting the risks of shorting stock.

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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### 4.3 *Options Trading Instruments*

- **Long call option**
- **Long put option**
- **Short call option**
- **Short put option**

#### 4.3.1 *Long Call Option*

A call can be purchased to open a long call position. As in the case of long stocks it is a debit trade. The call is purchased at the ask value of the options strike price based on the expectation that the stock price will rise. It gives you the right to buy the stock at a fixed price within a set time frame.

So a long call can be used when you expect the market to trend upwards in a bullish manner. **The call purchase gives you the rights to:**

- **Re-Sell the option**
- **Exercise the option**
- **Let the option expire**

You do not want to let the option expire because you will lose your investment in the call purchase. You could also exercise the option. In this case you must have the capital available to purchase the stock. So if you have executed a directional trade through the purchase of a call option, you will most likely want to re-sell the option to capture profit.

Example:

Based on your analysis you believe stock ABC will rise in value from its current price of \$40/share and so you purchase a 40 June Call. Let's say you buy 1 contract equating to 100 shares of stock. And consider the option price is \$2/share or \$200/contract. So you now control 100 shares of ABC stock for \$200 by purchasing the call option where you would have spent \$40/share x 100 shares equal to \$4,000 if you had purchased the stock.

So you have purchased a 40 June Call costing \$2/share. If the stock increases to \$45/share this gives you the right to buy the stock at \$40 (as the number 40 represents the strike price). You have the right to buy this stock until June at which point the option will expire. Options expire on the 3<sup>rd</sup> Saturday (options cease trading on the 3<sup>rd</sup> Friday of the expiration month) of the month, in this case June. As the stock increases in value so too will the option. This allows you re-sell the option at a profit without ever having owned the stock.

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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### 4.3.2 Long Put Option

A put can be purchased to open a long put position. As in the case of long calls it is a debit trade. The put is purchased at the ask value of the option's strike price based on the expectation that the stock price will fall. It gives you the right to sell stock at a fixed price within a set time frame. A long put can be used when you expect the market to trend downwards in a bearish manner. The put option will increase in value as the stock trends downwards. So, you can sell that put at a profit as the value of the stock decreases.

If you own a stock the put purchase can act as insurance because it gives you the right to sell the stock at a fixed price should the stock drop in value. This strategy is called the protective put and will be covered in more detail later.

The put purchase gives you the rights to:

- **Re-sell the option**
- **Exercise the option**
- **Let the option expire**

Similarly to the case of call options you will not want to let the option expire as you will lose your investment in that trade. You can also exercise the option which in this case means selling stock at a fixed price. For the most part you will want to re-sell the option to capture premium when the option becomes profitable.

Example:

Consider the same company ABC as before trading at \$40/share. Based on your analysis you expect the stock to decrease in value from its current price so you buy a 40 June Put. If the cost of purchasing the put option is \$2/share and you buy 1 contract you will pay \$200 (since 1 contract equates to 100 shares).

The number 40 in "40 June Put" refers to the strike price and is the value at which the stock can be sold. As in the case of the call option contract above, the put option will cease trading on the 3<sup>rd</sup> Friday of June. If the value of the stock drops to \$35 this gives you the right to sell stock ABC at \$40/share and therefore if you own the stock it protects you against a downtrend in the stock.

### 4.3.3 Short Call Option

A call can be sold to open a short call position. The call is sold based on the expectation that the stock will decrease in value. The short call obligates you to sell a stock at a fixed price within a set time frame. Since you are giving someone the right to buy the stock from you, you receive a premium for providing them the right and so the trade is a credit trade. The premium you receive is the bid value of the options strike price.

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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In a directional trade the call is sold because you believe, based on your analysis, that, the stock will decrease in value. As part of a spread trade the short call is very effective in reducing cost basis. This will be covered in detail as part of the covered call and collar trade strategies.

For now consider only the case of the short call as a directional trade. If the stock rises in value above the strike price of the call you are obligated to sell the stock at the given strike price.

### **The short call obligates you to:**

- **Sell the stock if assigned**

Assignment means that you are obligated to carry out some action. In this case it means you are obligated to sell the stock. Effectively somebody previously purchased a call and has exercised their right to buy the stock at a fixed strike price and since you sold the call at that strike price you are obligated to sell the stock at that strike price.

Selling a call without combining it with any other trade is called a naked call. Brokerages have strict requirements about naked calls, such as account minimums of \$100,000. The reason for this is that in theory the risk is unlimited if the stock should soar above the strike price. It is for this reason that it is recommended that you do not sell calls unless it is in combination with another trade, such as a covered call. And in the case of a covered call it can actually be a very effective way of proactively generating cash flow and hence increasing portfolio value. This will also be discussed later.

The intention in selling the call is to capture premium by allowing the option expire worthless based on your analysis and expectation that the stock will not rise above the strike price within a set time frame.

Example:

Consider the same company ABC as before trading at \$40/share. Let's assume you own the stock. Based on your analysis you don't expect the stock to rise in value above \$45 so you sell/short a 45 June Call. And for selling the call you receive a premium of say \$2.00 per share or \$200 per contract. This premium is deposited into your account upon trade execution. If the value of the stock remains less than \$45 during the set time period then the 45 June Call will expire worthless and you will keep the entire premium of \$200 per contract. If you owned 1000 shares of stock and sold 10 contracts you would have profited \$2/share x 1000 shares or \$2,000 provided the stock stayed below \$45/share until the 3<sup>rd</sup> Friday in June.

If the value of the stock exceeds \$45/share then you will be assigned the option and must sell stock ABC at \$45/share. So you will profit in the stock from \$40 to \$45 and you will also profit from the option premium received. However, you will not profit from any

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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increases in stock price above \$45/share. Again this covered call strategy will be expanded upon later.

### ***4.3.4 Short Put Options***

A put can be sold to open a short put position. The put is sold based on the expectation that the stock will increase in value. The short put obligates you to buy a stock at a fixed price within a set time frame. Since you are giving someone the right to sell the stock from you, you receive a premium for providing them the right and so the trade is a credit trade. The premium you receive is the bid value of the options strike price.

In the case of short put options your risk is limited to the strike price of the put. For example if you sold a put option at a strike price of \$20 and the stock dropped all the way to zero you would have received a premium for selling the put, say \$2/share, but would now have to purchase the stock at \$20/share if assigned.

**The short put obligates you to:**

- **Buy a stock if assigned**

So if somebody purchased a put and exercises their right to sell their stock at the set strike price at which you sold the put, then you would be obliged to buy the stock at that same strike price. This will only ever happen if the stock drops below the strike price. You cannot be assigned a short put option if the stock remains above the strike price.

Example;

Consider the same company ABC as before trading at \$40/share. Based on your analysis you believe the stock will increase its price per share so you sell a put option to generate credit with the intention of letting the option expire worthless.

So let's say you short a 40 June Put and receive \$2/share premium. This \$2/share premium is the maximum profit potential of the short put directional trade and the funds are deposited in your account upon trade initiation. If the stock is less than \$40/share you will be obliged to buy the stock at \$40/share (i.e. the stock price is lower than the strike price). If the stock is greater than \$40/share you keep the entire premium of \$2/share or \$200 per contract

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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### 4.4 Options Trading Instruments Summary

| Option            | Trend   | Stock>Strike Price                                                                                                              | Stock<Strike Price                                                                                                              |
|-------------------|---------|---------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|
|                   |         |                                                                                                                                 |                                                                                                                                 |
| <b>Long Call</b>  | Bullish | Right to <ul style="list-style-type: none"><li>• Re-sell option</li><li>• Exercise option</li><li>• Let option expire</li></ul> | Option purchase investment will lose value, may be able to re-sell and capture time value premium                               |
| <b>Long Put</b>   | Bearish | Option purchase investment will lose value, may be able to re-sell and capture time value premium                               | Right to <ul style="list-style-type: none"><li>• Re-sell option</li><li>• Exercise option</li><li>• Let option expire</li></ul> |
| <b>Short Call</b> | Bearish | Obligated to sell stock if assigned                                                                                             | Let option expire & capture entire premium as profit – combine with stock purchase                                              |
| <b>Short Put</b>  | Bullish | Let option expire & capture entire premium as profit                                                                            | Obligated to buy stock if assigned                                                                                              |

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

### 4.5 Options Terminology

In order to correctly apply your trading strategies you will need to have a good understanding of options terminology.

| Terminology               | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|---------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Strike Price</b>       | All equity options have a specific price at which a stock can be bought or sold if the option is exercised. This is the strike price or exercise price.<br>If you own a call option you can exercise your right to buy 100 shares of a particular underlying stock at the specified strike price. Similarly if you own a put option, you can exercise your right to sell 100 shares of a particular underlying stock at a specified price.                                                      |
| <b>Expiration Date</b>    | Expiration date is the last day on which an option can be exercised. Options cease trading on the third Friday of each month and expire the next day.                                                                                                                                                                                                                                                                                                                                           |
| <b>In The Money*</b>      | An option with intrinsic value is said to be in-the-money. A call is in-the-money when the market price of the underlying stock is greater than the option's strike price.                                                                                                                                                                                                                                                                                                                      |
| <b>At The Money*</b>      | When the underlying stock sells at the same price as the strike price of the option, the option is said to be at-the-money                                                                                                                                                                                                                                                                                                                                                                      |
| <b>Out Of The Money*</b>  | If an option has no intrinsic value, it is considered out-of-the-money. A call is out of the money when the strike price is higher than the market price of the underlying stock. A put is out of the money when the strike price is lower than the market price of the underlying stock. The entire premium of an out-of-the-money option is due to its time value.                                                                                                                            |
| <b>Open Interest</b>      | Open interest is the number of outstanding contracts and can be used to determine group expectation for a particular stock.                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Intrinsic Value*</b>   | Intrinsic value is the difference between an in-the-money option strike price and the current market price of a share of the underlying stock.                                                                                                                                                                                                                                                                                                                                                  |
| <b>Extrinsic Value*</b>   | Extrinsic value is any other value the option has over and above the intrinsic value.<br>EX: Long Call Strike 50 that costs \$3. Assume Stock is at \$51.<br>Intrinsic value = $\$51 - \$50 = \$1$ → Extrinsic value = $\$3 - \$1 = \$2$                                                                                                                                                                                                                                                        |
| <b>Volume</b>             | For options this the number of contracts that have been traded in a specific time period, usually a day or week                                                                                                                                                                                                                                                                                                                                                                                 |
| <b>Implied Volatility</b> | Implied volatility is the assumption of the stock's volatility that helps determine the options price. All other factors in the options pricing model are assumed to be known so the implied volatility is calculated last after other options pricing parameters have been calculated. Increased implied volatility increases the value of an option and decreased implied volatility decreases the value of an option. It can be thought of as the value of an option based on current market |

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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|                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|-------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                   | sentiment of future fluctuations in the stock. So news events such as earnings releases, upgrades and downgrades will affect implied volatility.                                                                                                                                                                                                                                                                                                                                         |
| <b>Time Value</b> | Time value or time premium is the difference between the total cost of an option and its intrinsic value. So it's the amount people are willing to pay over and above the intrinsic value. It is length of time from the date of purchase to the expiration date. The further out the expiration date the greater the time value.                                                                                                                                                        |
| <b>Time Decay</b> | This is the loss in value of an option over time when all other factors remain constant. It is a non-linear decrease with the greatest effect being in the last 30→45 days of an option's life.<br>So in the last 30→45 days if you own a long option it would be prudent to re-sell that option or exercise that option because time decay will be acting against you. So time decay causes long options to lose value. Conversely if you short options, time decay is working for you. |
| <b>Delta</b>      | This is the rate of change of the options price relative to a one unit change in the price of the stock. For example if a call option has a delta of 0.75 then for a \$1 increase in the price of the stock the option will increase by \$0.75                                                                                                                                                                                                                                           |
| <b>Assignment</b> | A random process in which options buyer informs broker of wish to exercise option. Broker informs options exchange that in turn informs options clearing corporation. OCC returns to options exchange that randomly picks a broker and the broker picks a short option holder to assign by a fair but not necessarily random method.                                                                                                                                                     |

\* See options chain below



## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

### 4.6 Options Chain

In order to understand option chains, some examples will be discussed. The format shown is typical of brokerage representations.

| CALLS      |       |     |       |       |        |               |               | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|---------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike        | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ<br>@20.87 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |               |           |       |      |       |       |        |               |
| XYZFW      | 3.600 | 0   | 3.600 | 3.700 | 64     | 11,752        | 17.50         | XYZRW     | 0.200 | 0    | 0.200 | 0.250 | 430    | 5,709         |
| XYZFD      | 1.650 | 0   | 1.650 | 1.750 | 429    | 7,821         | 20.00         | XYZRD     | 0.800 | -0.1 | 0.650 | 0.800 | 592    | 6,409         |
| XYZFX      | 0.500 | 0   | 0.500 | 0.550 | 683    | 4,111         | 22.50         | XYZRX     | 2.050 | +0.1 | 2.050 | 2.200 | 85     | 711           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 12     | 1,382         | 25.00         | XYZRE     | 4.100 | 0    | 4.100 | 4.300 | 1      | 142           |

The first thing you should pay attention to in the above chain is the symbol and stock price located under the Strike column. You can see that this is the option chain for XYZ and that the stock is trading at \$20.87.

The second piece of critical information is the expiration month – June in this case - shown in the adjacent columns and labeled as June Calls and June Puts. So these call and put options cease trading on the third Friday of June.

Under the middle column are the strike prices. Note that these are fixed prices. All the other numbers on the options chain can change depending on the stock price. So, if the stock price rises the calls will increase in value to reflect the increase in stock price and the puts will decrease in value to represent the stock value increase. The reverse will happen for a decrease in stock value.

Note that each call and put option has its own unique symbol. This is listed on the extreme left column for calls. The calls are used to identify the option (call/put), its strike price, expiration month and stock. It is not necessary to have an in-depth understanding of this, just the overall concept. Similarly the put options on the right side have unique symbols. These symbols will help you place trades by identifying which option you wish to buy or sell.

When you buy the option you will be purchasing it at the Ask price and when you sell the call or put option you will be selling at the Bid price. Note that the Ask price is always slightly greater than the Bid price. The difference is called slippage or spread and is the profit that the market maker receives by ensuring liquidity in the market place. So if you buy an option you are not going to sell it right away or you will lose money.

So if you wish to buy a June 20 Call you will pay the ask price of \$1.75 per share and since you will purchase a minimum of 1 contract equivalent to 100 shares, this equates to \$175 per contract. Similarly if you wish to purchase 1 June 20 Put contract you will pay \$0.80 per share or \$80.00 per contract.

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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If you wish to sell the June 22.50 call you will receive the bid price of \$0.50 per share. And for the June 22.50 put you will receive \$2.05 per share or \$205 per contract.

In order to understand the terms “in-the-money”, “at-the-money”, “out-of-the-money”, “intrinsic value” and “extrinsic value” mentioned in the options terminology section above, consider the following examples

**In-the-money:** In the options chain listed, the figures highlighted in yellow are in-the money. You know that the stock is trading at \$20.87. In the case of the call options this means that any call options with strike prices less \$20.87 will be labeled “in-the-money”. You can see that the June 17.50 and June 20 calls are therefore in-the-money.

The term “in-the-money” for the listed call options is effectively saying that while the stock is greater than their strike price, the call option always has some value at least equal to the difference between the stock price and the strike price. So, when you’re in-the-money your option will always have intrinsic value. In the case of the June 20 call the intrinsic value is \$0.87 which is the difference between the stock price and the strike price.

Note that this June 20 call option is in fact trading for a bid price of \$1.65 and an Ask price of \$1.75, both of which are greater than the \$0.87. This extra cost is the extrinsic value of the option and represents time value.

Conversely for puts, options that have strike prices greater than the stock price are said to be in-the-money. The June 22.50 put will have intrinsic value that equals the strike price minus the stock price ( $22.50 - 20.87 = 1.63$ ). The option in fact trades at a bid value of \$2.05 per share and an Ask value of \$2.20 per share. The difference between the intrinsic value and the actual value is the extrinsic value.

Therefore, put options with strike prices higher than the current stock price are said to be in the money.

In summary when you have an option that is in-the-money, the option will have intrinsic and extrinsic value.

**Out-of-the-money:** The call and put options that are not highlighted in yellow are said to be “out-of-the-money”. This is because the stock price is lower than the strike price in the case of the call options and higher than the strike price in the case of put options.

In the case of the June 22.50 call option, its entire value is extrinsic value. The option has no intrinsic value because the strike price is greater than the stock price. Similarly, the June 17.50 put option has no intrinsic value because the strike price is less than the stock price.

**At-the-money:** At the money means the value of the stock is equal to the value of the strike price. In the case above there is no option strike price equal to the stock price

## CHAPTER 4 – OPTIONS TRADING INSTRUMENTS

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of \$20.87 therefore no options exist at-the-money. If the stock were to decrease in value to \$20 then the June 20 call and June 20 put would be at-the-money.

### **4.7    *Summary***

Options trading instruments take the form long call, short call, long put and short put options. Trading these instruments alone can facilitate directional trading that will allow you profit in the market in one direction alone.

In order to understand how to reduce your risk in the market and profit even if your initial expectation of stock direction is incorrect you will need to know how to combine these trading instruments and you will learn this in the next section.

## **CHAPTER 5 –ELIMINATE FEAR - THE PROTECTIVE PUT**

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### **5.1    *Introduction***

At this stage you should have a basic understanding of options. This section will highlight two very important trading strategies that can be used to eliminate greed and fear in your trading. Probably the most important strategy in this course, the collar trade, will then be discussed. This strategy alone can generate returns exceeding 20% per annum - much higher if applied correctly - with little maintenance and very low risk. It is very important that you have a thorough understanding of this strategy as it should form the foundation of your trading strategy that will be your roadmap to financial freedom.

### **5.2    *The Protective Put – Eliminate Fear***

Buying put options in conjunction with owning a stock is a way to insure stock holdings. This is similar to the insurance you would purchase on a car or a home that you own. Let's consider you owned your home and it was worth \$200,000. If you were able to purchase insurance that would guarantee that, even if some disaster happened and your home dropped in value to \$100,000, you could still sell the home for \$200,000 would you purchase that insurance? Of course!

Similarly you can purchase insurance on your stock holdings such that beyond a certain point for every dollar decrease in stock value your put purchase will increase in value by one dollar offsetting the stock decrease. This will eliminate fear in your trading approach. In order to insure your stock you will need to pay for the put purchase. This will increase your cost basis for the trade. This is a small price to pay for the protection afforded you and as will be seen later in this chapter this premium can be offset by application of another strategy, the covered call.

As you can see the protective put eliminates fear in your trading since you know that even in the event of the stock decreasing to zero net worth you will still be able to sell the stock at a fixed price as a result of your put purchase. This strategy alone could save you a huge amount of money. There were many thousands of people in the boom period of 2000 that made a fortune in the up-trend of the "bubble" but lost a significant amount, if not all, of their holdings simply because they did not have protective puts in place to lock in their profits and principal and protect them from the subsequent market collapse.

If your stocks are purchased on margin, this strategy will ensure that you do not receive margin calls in the event of the stock decreasing in value to a point that would otherwise warrant a margin call. It is highlighted that for every 100 shares of stock owned, 1 put contract is purchased so that the long puts will offset the losses in the stock should it decline.

## **CHAPTER 5 –ELIMINATE FEAR - THE PROTECTIVE PUT**

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### ***5.2.1 When should I use a protective put?***

This question will largely depend on your diligence in following the market regularly and your risk tolerance. If you would prefer to guarantee at all times that your risk is kept to a known minimum amount then you should always have protective puts in place. This is advisable also for those that do not have a wealth of trading experience. On the other hand, if you follow the market quite closely and are aware of when the market is in an up-trend and when it is in a down-trend then you may wish to selectively apply protective puts. Since your put purchase will only make money in a down-trending market but will lose value in an up-trending or stagnant market you may wish to increase your risk tolerance in bullish markets by not applying protective puts. You should only do this when you are experienced at judging market conditions, skilled at following the market closely and maintain awareness of all factors that could change the direction of the market. For instance around earnings season you should always have your protective puts in place as it is a period of volatility and uncertainty.

### ***5.2.2 Lock In Profits***

You can use protective puts when the market has rallied for some period and you wish to lock in profits. Let's say you bought a certain stock at \$15 per share and it advanced over some period of time to \$20, you could now purchase protective puts at a strike price of 20 that will ensure that you lock in your 33% profit. This means irrespective of what the market does now, even if it drops down to \$15 again, you will have guaranteed that the \$5 profit you made is secure.

### ***5.2.3 Protect Against False Rallies***

In the 2 or 3 years following the market peak in 2000, a number of market rally attempts were made. Often these attempts would lull traders into a false sense of security where they believed the market had hit a bottom and was now ready to rise again. In many cases the market would subsequently drop again to a new low. In this sort of scenario where investors are attempting to pick the market bottom, the protective put strategy can be extremely valuable. In the event that you picked what you believed was the bottom, saw the stock rise for a period and then collapse below the point at which you purchased the stock you would guarantee that your risk was fixed to a certain amount that you had pre-defined prior to your trade execution.

### ***5.2.4 Time Frame***

As mentioned time decay accelerates during the last 30→45 days of an option's life. As a result you will want to purchase long put options with at least 3→6 months remaining before expiration.

## CHAPTER 5 –ELIMINATE FEAR - THE PROTECTIVE PUT

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### 5.3 *Protective Put Example*

Based on your analysis you believe stock ABC will increase in value from its current trading value of \$10 per share. However, the stock has had a history of volatility and you do not want to simply buy the stock without protecting it. So you buy 300 shares of stock and in order to protect that stock you buy 3 long puts 6 months from expiration, say June, at a strike of 10 and a cost of \$1.50 per share.

In summary your position is as follows:

- **Stock Purchase:** Bought 300 shares of ABC at \$10 per share → Total cost is 300 shares x \$10 per share = \$3,000
- **Long Put Purchase:** Bought to open 3 June 10 put contracts at \$1.50 per share → Total cost is 3 contracts x 100 shares/contract x \$1.50 / share = \$450

Your total cost basis is now the sum of the stock purchase cost and the long put purchase cost.

→ Total cost basis = \$3,000 + \$450 = \$3,450

The put purchases guarantees that you will not lose money if the stock decreases below \$10. The cost per share has increased by the amount you paid for the puts. In this case the stock is trading at \$10 so when you buy the stock alone your cost basis is \$10 per share. The put purchase has increased your cost basis by \$1.50 (the per share price of the put).

→ Per share cost basis / Breakeven point = \$10 + \$1.50 = \$11.50

Therefore you will not be making money on this trade unless your stock goes above \$11.50 but you will not lose any money if the stock decreases below \$10.

→ Maximum Risk = Cost Basis – Long Put Strike Price = \$11.50 - \$10.00 = \$1.50 per share of \$450 for 3 contracts

→ Maximum Reward is unlimited since theoretically the stock can keep going higher

If the stock now decreases to \$5 per share you will not have to worry because the puts you purchased will increase in value for every dollar decrease in the stock. The options will be worth at least \$5 per share or \$500 per contract. This is their intrinsic value. In fact there will be some time value associated with the option so it may in fact be worth more than \$5 per share.

If the stock increased to \$15 per share your profit would now be the difference between the current stock price and your cost basis. In this case \$15 - \$11.50 = \$3.50. So, your profit would be \$3.50 per share or \$1,050 for 300 shares.

## CHAPTER 5 –ELIMINATE FEAR - THE PROTECTIVE PUT

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### 5.4 *Protective Put Strategy Decisions*

In the example above you wanted to protect your entire \$10 per share stock purchase and bought an at-the-money put with a strike of 10. You could have assumed more risk and reduced your cost basis by buying an out-of-the-money put at a strike of say 7.50.

In this case the premium for the put purchase would be much less than the \$1.50 you paid for the strike 10 put but you would only be protecting your stock if it fell below \$7.50. The tradeoff between cost basis and risk is one you will continually make when applying the protective put strategy.

### 5.5 *Protective Put Summary*

Prior to entering any trade you wish to execute you should always have your primary and secondary exit points defined. These will allow you trade in a disciplined manner. Your primary exit point will define what your target profit for the trade is and your secondary exit point will define what your maximum loss is for the trade. You should always calculate the parameters below prior to entering any trade.

| Critical Parameter | Description                                                |
|--------------------|------------------------------------------------------------|
|                    |                                                            |
| Cost Basis/Share   | Cost/share of stock + Cost/share of put (Ask price of put) |
| Maximum Risk       | Cost Basis/Share – Strike price of put                     |
| Maximum Gain       | Unlimited once stock increases past breakeven point        |
| Breakeven Point    | Cost/share of stock + Cost/share of put                    |

The protective put eliminates fear in your trading by providing insurance on your stock positions in the event of the market moving down and your stock position losing value. You can also use this strategy to lock in profits if the stock moves up to your target profit point. By purchasing a put at that target profit point you ensure that even in the event of the stock decreasing your profits are safe.

## **CHAPTER 6 –ELIMINATE GREED – THE COVERED CALL**

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### **6.1 *Introduction***

Selling call options in conjunction with owning a stock is a way to reduce cost basis on a trade. Application of this strategy can result in you reducing your cost basis to zero on stock owned.

It is also an excellent method for eliminating greed in your trading. One of the common pitfalls people fall into when trading is the reluctance to sell stock when it hits a certain target. When entering a trade they may be happy with a 20% increase in stock value but once the stock gains that 20% they become greedy and believe the stock could etch out further gains. Often a correction will occur subsequent to a run-up in stock price and you can find yourself sometimes with a much smaller profit or even a loss – all because of greed.

The covered call eliminates greed in your trading approach by pre-defining your maximum gain prior to trade execution and simultaneously reducing your cost basis of the trade.

It cannot be over-emphasized that you should always have your exit points pre-defined so that you do not give in to greed or fear. Your primary exit point should set your target profit for the trade and your secondary exit point should define the maximum loss or minimum gain in the trade and what strategy you should employ to minimize losses or maintain profits. This will be covered in greater detail later.

### **6.2 *When should I use a covered call?***

Anytime you own a stock it is a good idea to write or sell out-of-the-money calls. Why? Because every time you sell such a call you reduce your cost basis.

In theory selling a call is a bearish strategy since you profit when the stock decreases in value. However, it is advisable to sell calls in neutral, bearish and mildly bullish market trends provided of course you own the stock. In extremely bullish conditions you may make a decision that there is greater potential that the stock will move well above the strike price at which you could sell the call and so you do not want to limit your maximum profit by selling the call.

#### **6.2.1 *Time Frame***

You should sell the calls short term, with only 60 days to expiration as time decay will erode their value most rapidly during this period and you can profit from that decay



## CHAPTER 6 –ELIMINATE GREED – THE COVERED CALL

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### 6.2.2 *Owning Stock For Zero Cost Basis*

If you owned a stock trading at \$20 per share and you sold a \$25 call for \$1 your cost basis would reduce to \$24. So when the option you sell expires and you profit 100% from the credit received, you can sell another call and further reduce your cost basis. If you repeat this enough times eventually you will own the stock for zero cost basis even though it may be trading at say \$20 per share. This means that your entire stock ownership is effectively free and is entirely comprised of profit so there is no possibility of you losing on that trade!

This strategy is designed to increase your portfolio value each and every month by being able to cash flow money through receiving credit from writing the calls. It is intended to increase your portfolio net worth by incremental amounts all the time. The approach of trying to pick the next stock that will sky rocket and make you a fortune in a short period is highly unreliable whereas if you consistently increase your net worth by small amounts you will find one day it has turned into a huge amount.

### 6.3 *Covered Call Example*

Let's say you want to reduce the cost basis on 200 shares of stock ABC that you bought for \$23 per share. You also want to set a pre-defined primary exit point of \$30 per share. This means you want to sell 2 call option contracts equivalent to 200 shares on stock ABC at a strike price of 30. You will want to maximize the use of time decay which is most significant within the last 60 days of the option's life so let's say that means you sell the April 30 call for a credit of \$2 per share.

In summary your position is as follows:

- **Stock Purchase:** Bought to open 200 shares of ABC stock at \$23 / share → Total cost is 200 shares x \$23 / share = \$4,600
- **Short Call:** Sold to open 2 April 30 call contracts at \$2 / share → Total cost is 2 contracts x 100 shares/contract x \$2/share = \$400

This tells you that you have just received \$400 for entering a contract in which you agree to sell 200 shares of ABC stock at \$30/share if the stock trades above that value prior to expiration of the call options. So, if the stock trades at \$35 prior to the 3<sup>rd</sup> Friday of April when your April options will cease trading then you will not make any profit from \$30 to \$35.

Your cost basis for this trade has reduced from \$23/share to \$21 per share which is the difference between the stock price and the call credit received.

→ Cost basis per share = Stock price – Credit per share of short call = \$23 - \$2 = \$21

## CHAPTER 6 –ELIMINATE GREED – THE COVERED CALL

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This means that your breakeven point is at \$21 even though the stock is trading at \$23. So you will not be losing money on this trade unless the stock decreases below \$21/share.

Maximum gain per share = Strike price of out-of-the-money call sold – cost basis per share

➔ Maximum gain = \$30 - \$21 = \$9

You can see that your return on investment increases also by selling the out-of-the-money call. If you had simply purchased the stock and watched it trend up to a trading value of \$30 then your return would be \$7 on a \$23 investment or 30%. By selling the call options you can increase your return on investment to 42% (\$9 return on \$21 investment)

### 6.4 Covered Call Strategy Decisions

The question of what short call to enter really depends on your own risk tolerance and the reward potential you are striving for. Call options that are approximately 60 days from expiration are ideal for this kind of strategy as time decay will affect them most in this period and they will still have enough premium left to make the trade execution worthy.

If the stock does exceed the strike price of the call sold prior to expiration and you are assigned such that you have to sell the stock at the strike price then it means you have profited fully from your trade and realized your primary exit point. If you are still bullish on the stock you can buy the stock again and continue selling covered calls.

If the stock never reaches the strike price and the options expire worthless you will continue to reduce your cost basis on the trade and hence reduce your risk exposure on the trade. It is an excellent way to create cash flow on existing stock positions.

### 6.5 Covered Call Summary

| Critical Parameter | Description                                                  |
|--------------------|--------------------------------------------------------------|
|                    |                                                              |
| Cost Basis/Share   | Cost/share of stock - Cost/share of call (Bid price of call) |
| Maximum Risk       | Cost Basis/Share                                             |
| Maximum Gain       | Strike price of call – cost basis/share                      |
| Breakeven Point    | Cost/share of stock - Cost/share of call                     |

The covered call will enable you reduce cost basis on your stock positions, create cash flow regularly by selling calls with approximately 60 days left to expiration and limit the profits you can make on your trade within a set time frame, thereby eliminating greed from your trading.

# CHAPTER 7 – GRAB THE BULLS AND BEARS BY THE COLLARS

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## 7.1 *Introduction*

The collar trade is a popular trade that often forms the basis of a trading strategy. It is a combination of the protective put and the covered call strategies. It allows you execute trades at very low risk and still generate good returns. In certain situations it can be a no risk trade or even generate a guaranteed return. Correct application of this trade could generate returns exceeding 20% per annum and will require little maintenance.

One of the keys to this strategy is it allows you trade on margin without risking a margin call since the protective put is in place. What does this mean in practice? It means that if you structure a collar trade such that you guarantee a gain of 20% and with margin, this translates to a 40% gain in value without margin (assuming you are entitled to 50% margin in your brokerage account and neglecting margin interest). If you have set up your trade to be a no-risk trade which is very possible then you can be assured that no matter what happens in the market you will not lose any capital, except that due to commissions and slippage of course, and your maximum gain is determined to be 40%. If you could increase a \$10,000 portfolio by 40% over ten years it would translate to almost \$290,000.

A number of reasons exist why this trade should be the foundation of your trading strategy. Firstly it pre-defines your exit points in the trade. Prior to entering the trade you know that the maximum gain you can achieve from the trade is, say 28%, and the maximum loss is 6%. As mentioned earlier greed can often turn a profitable position into a loss because a trader does not define his/her exit points prior to the trade. Fear can also cause losses. Perhaps a position is entered and let's say a news event temporarily causes your stock to dip in price, you may be tempted to exit that position in spite of the fact that all fundamental and long term indicators suggest your original purchase had a lot of merit. In this case fear of a further down trend and hence selling your stock could cause you to needlessly miss out on profits. The collar trade will prevent against this because you will not be worried about a down trending market.

The collar trade is a relatively conservative strategy. This is another reason why it should be the foundation of your trading approach. It ensures that your principal is always quite safe and you have protected yourself against large market swings. Correct application of this strategy will allow you profit consistently in any market condition.

## 7.2 *Collar Trade Structure*

The collar trade consists of buying shares of a particular stock, buying a long put –usually at-the-money or slightly out-of-the-money – and selling an out-of-the-money call. It is advisable to execute the positions simultaneously so there is no unnecessary risk exposure.

If you prefer to execute the trade with the expectation that you will not be monitoring it regularly, you can buy and sell LEAPS options. LEAPS are long term options that expire

## CHAPTER 7 – GRAB THE BULLS AND BEARS BY THE COLLARS

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on the 3<sup>rd</sup> Friday of the following January. So for instance in June 2006 you will find LEAPS options for January 2007 and even January 2008. These options usually have quite a lot of time value built in. In fact since the natural tendency of the market is to increase over time the call options can often be of greater value than the put options. This is very advantageous to collar trade executions since the debit for your put option will be offset by the credit in your call option. Your stock purchase will be the largest capital investment in the trade. However, if the short call option credit exceeds the long put option purchase you will have reduced your cost basis on your stock purchase and simultaneously defined your maximum gain and maximum risk in the trade.

For every long put purchase contract or short call contract written you should always make sure you have 100 shares of stock ownership.

### ***7.3 Collar Trade Example***

Consider a collar trade where you buy 100 shares of ABC stock at \$45 per share, you purchase a LEAPS 45 long put that has a bid value of \$4.80 and an ask value of \$5.00 and short a LEAPS 60 call that has a bid value of \$3.00 and an ask value of \$3.30.

You now need to determine what your cost basis in the trade is, what your maximum risk in the trade is and what your maximum gain is.

Cost Basis:

**Cost Basis Per Share = Stock price/share + Ask Price Of Put Purchase/Share – Bid Price Of Short Call/Share**

➔ Cost Basis Per Share = \$45 + \$5 - \$3 = \$47

This means that this trade is not profitable until the stock exceeds \$47/share.

**Maximum Risk Per Share = Difference between cost basis per share and put strike price**

➔ Maximum Risk Per Share = \$47 - \$45 = \$2

**Maximum Gain Per Share = Difference between short call strike price and cost basis per share**

➔ Maximum Gain Per Share = \$60 - \$47 = \$13

This maximum gain per share is \$13 based on a \$47 dollar investment. This equates to a 27.6% maximum gain. If the stock was purchased on margin, your maximum gain effectively doubles to approximately 55%.

## CHAPTER 7 – GRAB THE BULLS AND BEARS BY THE COLLARS

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In the above case your maximum risk is \$2 per share neglecting the nominal interest fees and commissions.

This trade now requires no maintenance if you so wish. You can be sure that no matter which way the stock moves you will not lose more than 8% on this trade and prior to expiration your maximum reward is 27.6%. This is an attractive risk/reward ratio for such a low maintenance trade and eminently realistic too.

### ***7.4 Collar Trade Strategy Decisions***

If you wish to reduce your cost basis further you can do so by assuming more risk by purchasing an out-of-the-money put. If you are very bullish on the stock you can also short an even further out-of-the-money call that will increase your maximum reward potential but will not decrease your cost basis as significantly as a short call closer to the stock price.

This strategy is ideal for execution with LEAPS options where you do not have the time or inclination to monitor your trades regularly but want to have the peace of mind to know your investments are not exposed to any significant risk should the market collapse.

It cannot be over emphasized that this strategy should form the foundation of your trading strategy. If applied correctly it will never expose your principal to significant risk and can even be executed to be a no risk trade.

### ***7.5 Collar Trade Summary***

| Critical Parameter      | Description                                                                    |
|-------------------------|--------------------------------------------------------------------------------|
|                         |                                                                                |
| <b>Cost Basis/Share</b> | Cost/share of stock + Cost/share of put (ask price) – Cost/share of call (Bid) |
| <b>Maximum Risk</b>     | Difference between cost basis/share and put strike price                       |
| <b>Maximum Gain</b>     | Difference between short call strike price and cost basis/share                |

## CHAPTER 7 – GRAB THE BULLS AND BEARS BY THE COLLARS

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### 7.6 *The Million Dollar Question*

***The million dollar question is how do you profit consistently in any market condition?***

The above discussion on the collar trade gives you an excellent starting point where you know how to execute a trade that has maximum gain and maximum risk pre-defined. But what happens if the market does decrease? Are you really willing to accept the 8% loss mentioned above or do you want to turn the market down-trend into a profit-making scenario? Of course you want to profit from the down trend and the way to consistently profit in the market is to realize that ***you can adjust your trades to the current trend in order to maintain profits.***

So in the example above how would we take advantage of a down trend? Let's say the stock fell to \$30/share is there anything we can do other than suffer the loss? Absolutely!

Prior to entering the trade you should have done your fundamental analysis that would have indicated that this is a good stock to hold long term. The collapse in price will therefore have come as a surprise to you. However, if your original analysis was correct the stock will have good long term growth prospects and so you will expect it to rebound. The intention when entering collar trades is to hold the stock for a minimum of 1 year to take advantage of tax benefits for long term stock holdings. Is there potential for the stock to increase back to \$45/share or greater in 1 year? There certainly is! So, with that overview you will want to profit from this down trend.

In the example above to profit from the down trend there are two adjustments to the trade you can make keeping in mind you do not want to sell the stock. The first adjustment involves selling the LEAPS 45 put. This put will have increased in value for every dollar decrease in stock price. So, if the stock has fallen to \$30, the put will be worth at least \$15/share. Since you purchased the put for \$5/share you have just made a 200% profit gain in the put.

You can also buy back the call. Given that the stock is now at \$30/share the call will have very little value at all, say \$0.50/share in this example. So, you sold the call for \$3/share and have now bought it back for \$0.50 – a \$2.50 profit per share!

The purpose of this transaction is to profit from the downward movement. However, the transaction is not yet complete as the stock currently has no protective put or covered call in place. You should now purchase a long put at a strike of \$30 and sell a call at a strike of say \$45. This means you have essentially rolled down the collar trade. You have taken the profit from the downward movement in the stock, protected yourself against any further downward movement and defined your maximum profit while reducing your cost basis through your short call.

Now if the stock trends back to \$45/share you will have profited from the initial surprise downward movement through the put and call adjustments when the stock trends up again.

## CHAPTER 7 – GRAB THE BULLS AND BEARS BY THE COLLARS

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### 7.7 *Collar Trade Adjustment Summary*

This section details the strategy to maintaining consistent profits in the market by adjusting your trades to the current trend.

The first thing you should do is define your primary and secondary exit points. Your primary exit point in this case will be when the stock reaches or exceeds the strike price of the short call such that the maximum profit is attained. You can define your secondary exit point as the trade adjustment you will make when the stock drops by say \$5 below the strike price of your put (assuming you bought an at-the-money put – if you purchased an out-of-the-money put and therefore accepted more risk you might want to adjust when the stock goes \$2.50 below your put strike price).

#### 7.7.1 *Collar Trade Adjustment Example*

| Open Position                                                                                                                           | Primary Exit Point                                                                                                                                                                                                                                                                                                                          | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                                     |
|-----------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Stock at \$20/share</li><li>• Short call at strike 30</li><li>• Long put at strike 20</li></ul> | <ul style="list-style-type: none"><li>• Maximum gain achieved when stock is at least \$30/share at expiration.</li><li>• Short call is assigned at expiration when stock is above short call strike price.</li><li>• Stock profits from \$20 to \$30 and short call premium is kept when assigned.</li><li>• Sell long put option</li></ul> | <ul style="list-style-type: none"><li>• Secondary exit point coincides with adjustment point when stock falls to \$15/share</li><li>• Sell strike 20 put to capture profit from put</li><li>• Buy back strike 30 call to capture profit from call</li><li>• Buy strike 15 put</li><li>• Sell strike 25 call</li></ul> |

### **8.1    *Introduction***

It was mentioned earlier that the collar trade should form the foundation of your trading strategy. A thorough understanding of the collar trade, primary and secondary exit point and the adjustment process will position you to profit consistently in all market conditions. This section will outline call spread trade strategies that do not involve stock ownership and hence require less capital investment than the collar trade strategy. If you are relatively inexperienced in trading options it is advised that you gain a thorough understanding of the collar trade prior to executing the strategies outlined in this section. These trades can be used on their own or in conjunction with collar trades to allow you profit two-fold, once with the collar trade and once through execution of call spread trade strategies.

The call spread trades outlined in this section will show you how to profit in bullish, bearish and stagnant market conditions.

### **8.2    *Bull Call Spread Trade***

The bull call spread trade is a bullish strategy that requires an up-trending market to generate profits. You are already aware that the purchase of a long call is a bullish strategy so how is the bull call spread trade different? The critical thing to note is the trade is a spread trade so it will require more than a single trading instrument.

**The bull call spread trade consists of:**

- **Long call**
- **Short call**

The long call is the primary trading instrument as it will generate the profit in the trade and the short call will reduce the cost basis or risk in the trade. The same expiration month is used for both long and short calls.



## CHAPTER 8 – CALL SPREAD TRADES

### 8.3 Bull Call Structure

The structure of the trade is as follows:

| Option     | Application                                                                                                          |
|------------|----------------------------------------------------------------------------------------------------------------------|
| Long call  | Buy to open at-the-money or slightly out-of-the-money long call option at the ask price                              |
| Short call | Sell to open out-of-the-money short call option at the bid price one or two strike prices above the long call option |

### 8.4 Bull Call Spread Trade Example

In order to understand this let's structure a bull call spread trade from the option chain below:

| CALLS      |       |     |       |       |        |               | Strike     | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest |            | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

From this option chain we can see that XYZ is trading at \$20.04. In order to execute a bull call spread trade we are only interested in the call options on the left hand side. The stock is currently trading close to the strike 20 call so it is effectively at-the-money. This will define the point where you will purchase your long call option.

➔ **Purchase long call at strike 20 ask price for \$1.55/share debit**

What strike price should you use for the short call? You can see from the option chain above that the strike 25 call has a bid price of \$0.05. Although selling this call will increase your profit potential (since you will be able to profit up to \$25), the bid price of \$0.05 is not an attractive credit unless you are selling a huge number of contracts (\$0.05/share equates to \$5 credit per contract) and were very confident of a bullish trend that would exceed \$22.50 (the other potential strike price) in the time frame prior to expiration.

➔ **Sell short call at strike 22.50 bid price for \$0.45/share credit**

## CHAPTER 8 – CALL SPREAD TRADES

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Now you will want to determine the net debit from this transaction which is the credit from the short call subtracted from the debit from the long call.

$$\rightarrow \text{Net debit/share} = \text{Risk} = \$1.55 - \$0.45 = \$1.10$$

The gain/share for this transaction is calculated by subtracting the net debit from the difference between the strike prices. This is because the long call only makes money when the stock is greater than \$20 (the long call strike price) and by selling the short call at a strike of 22.50 you will not be making money above \$22.50. This is because shorting the call at this strike means you are entering a contract to agree to sell shares of stock XYZ above \$22.50 in exchange for the credit you will receive.

$$\rightarrow \text{Max gain/share} = (\$22.50 - \$20.00) - \$1.10 = \$1.40$$

### 8.5 *Bull Call Primary & Secondary Exit Points*

So now you are almost ready to execute this trade. You must first define your exit points. As with other debit trades your *primary exit* point will set a return on investment value that is the point at which you will close the trade and hence control your greed.

Your *secondary exit* point should be well-defined also and is critical to maintaining consistent profits or limiting losses by controlling fear. The key to maintaining consistent profits, as with the collar trade, is by adjusting the trade to a new spread trade. In order to do this you must have a thorough understanding of the current trend and the trading instruments you are using. It is up to you to decide what percentage of your investment you are willing to risk and what percentage return you wish to obtain.

If there is trend change from bullish to bearish or stagnant you can adjust your bull call to a different spread trade. You will have to validate the trend change through your technical analysis such as your RSI and MACD indicators and your trend lines.

In the case of the bull call you would adjust the trade to a bear call or a call calendar as shown in the sections below.

## CHAPTER 8 – CALL SPREAD TRADES

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### 8.6 *Bull Call Spread Trade Summary*

The bull call spread trade is a debit trade and the long call is the primary trading instrument that generates the profits in the trade.

| Open Position                                                                                                                                                                                                                 | Primary Exit Point & Adjustment                                                                                                                                                                                                            | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                               |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Purchase at-the-money or just out-of-the-money long call option</li><li>• Sell out-of-the-money short call option one or two strike prices higher than the long call option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Maximum gain/share will be difference between strike prices – net debit</li></ul> | <ul style="list-style-type: none"><li>• Your net debit will be the difference between long call debit and short call credit</li><li>• Decide on % loss you are willing to accept in event of trend change</li><li>• If you wish to adjust trade, you can convert it to a bear call or a call calendar</li></ul> |

Always make sure to purchase the same number of long call contracts as short call contracts sold so you will not risk opening naked call positions through selling the short call without protecting the position through the long call option.

It is also noted that selling the out-of-the-money call option offsets time value decay in the lower strike long call position. This is a major advantage over simply buying a long call option.

## CHAPTER 8 – CALL SPREAD TRADES

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### 8.7 *Bear Call Spread Trade*

The bear call spread trade is a bearish or neutral strategy that requires a down trending or stagnant market to generate profits.

**The bear call spread trade consists of:**

- **Short call**
- **Long call**

The *short call is the primary trading instrument* as it will generate the profit in the trade and the long call will limit risk in the trade. Without the long call position, the short call would be a naked call and your risk would theoretically be unlimited since theoretically there is no limit to how high the stock price could go. The same expiration month is used for both long and short calls.

This trade is a credit trade as the credit received from the short call will exceed the debit paid for the long call option. If the stock price decreases below the short call strike then you can let both option positions expire worthless and hence avoid paying commissions to exit the trade and realize the entire credit as profit

It is preferable to execute this trade with about 30 days left to expiration so you take full advantage of time decay accelerating over this period. You will need to be confident that the stock is at a resistance level and is not likely to break through the resistance to the upside.

### 8.8 *Bear Call Trade Structure*

The structure of the trade is as follows:

| Option     | Application                                                                                                           |
|------------|-----------------------------------------------------------------------------------------------------------------------|
|            |                                                                                                                       |
| Short call | Sell to open at-the-money or slightly out-of-the-money short call option at the bid price above your resistance point |
| Long call  | Buy to open out-of-the-money long call option at the ask price one or two strike prices above the short call option   |

## CHAPTER 8 – CALL SPREAD TRADES

### 8.9 Bear Call Spread Trade Example

As in the case of the bull call spread trade the option chain listed will be used to help understand the bear call spread trade strategy.

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

As in the case of the bull call spread trade example can see that XYZ is trading at \$20.04. Let's assume based on your technical analysis that you believe resistance for XYZ is at \$20 and the stock is currently spiking slightly above that level but you fully expect it to decrease and remain below this level prior to expiration.

In order to execute a bear call spread trade we are only interested in the call options on the left hand side just as we were in the bull call spread trade. The stock is currently trading close to the strike 20 call so it is still effectively at-the-money. This will define the point where you will short your call option.

➔ **Sell to open short call at strike 20.00 bid price for \$1.45/share credit**

In order to limit your risk on the trade you will want to purchase the strike 22.50 call.

➔ **Buy to open long call at strike 22.50 ask price for \$0.50/share debit**

The result of these two transactions will be a credit to your account and will be the difference between the credit for the short call and the debit for the long call.

➔ **Net credit/share = Maximum Gain = \$1.45 - \$0.50 = \$0.95**

The maximum risk per share is calculated by subtracting the net credit per share from the difference in strike prices

➔ **Maximum Risk/share = (\$22.50 - \$20.00) - \$0.95 = \$1.55**

When you attempt to execute this trade your broker will require that you have enough trading capital available prior to the execution. This is usually done automatically in order to prevent you from entering positions in which you are not capable of covering should the need arise.

## CHAPTER 8 – CALL SPREAD TRADES

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### ***8.10 Bear Call Primary & Secondary Exit Points***

In this trade your primary exit point is to capture the entire credit from initiating the trade when the options cease trading at the close of business on the third Friday of June. This will be realized if the trend is stagnant or bearish. Alternatively you could set a percentage target at which you would exit the trade by buying back the short call option and selling the long call option.

You must decide what percentage loss, if any, you are willing to accept as your secondary exit point. You could determine that the breakeven point is the time when you wish to exit the trade. This is the point where the stock price would equal the sum of the short call strike price and the net credit for the trade.

A second strategy for your secondary exit point would be convert the bear call spread trade to a bull call spread trade in the event of the trend turning bullish as validated by technical analysis indicators and trend lines. If this were the case and the stock trended up by a couple of dollars you would maintain the long call position at strike 22.50 and sell the strike 25 call position. The new short call position would lower your cost basis for the trade and potentially turn a losing trade into a winning trade. It should be noted however that if this trade is executed with only 30 days left to expiration then there will be very little time value associated with the new higher strike short call. As a result the breakeven point exit strategy is most likely the one that should be adhered to. However, if you have executed a long term bear call this trade adjustment will be valid and will most likely be worth executing.

For the bull call trade considered in the first section the adjustment in the case of the trend turning bearish would involve maintaining the long call at strike 20 and selling the strike 17.50 call option. You should be aware that the potential does exist to turn losing positions into winning positions by adjusting your trades to the current trend to maintain profitability.

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### 8.11 Bear Call Spread Trade Summary

The bear call spread trade is a credit trade and the short call is the primary trading instrument that generates the profits in the trade. The trade takes advantage of bearish or stagnant trends.

| Open Position                                                                                                                                                                                                                | Primary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                         | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell an at-the-money or just out-of-the-money short call option</li><li>• Buy out-of-the-money long call option one or two strike prices higher than the short call option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point or decide that you want to capture the entire credit as profit by allowing the options expire</li><li>• Maximum gain/share will be the net credit that is the difference between the short call credit and the long call debit</li></ul> | <ul style="list-style-type: none"><li>• Maximum risk will be the net credit subtracted from the difference between the long call strike price and the short call strike price</li><li>• Decide on % loss you are willing to accept in event of trend change. When the stock trends up to the equivalent price of the short call strike price + the net credit, this is your breakeven point.</li><li>• If you executed the trade with very little time left then adjustment may not make sense because the higher strike short call will not have sufficient time value to warrant a trade</li></ul> |

Always make sure to purchase the same number of long call contracts as short call contracts sold so you will not risk opening naked call positions through selling the short call without protecting the position through the long call option.

In times of volatility or around earnings season, it is very possible that good news good result in a gap up in the stock. As a result it is a good idea not to enter this trade at such times so you are not surprised by unexpected news.

### ***8.12 Call Calendar Spread Trade***

A call calendar spread trade is a neutral time spread. Unlike the bull call and bear call spread trades that involved buying and selling different strike prices with the same expiration month, this strategy involves buying and selling the same strike price with different expiration months.

The long term option is purchased with the expectation that the stock will trend upwards prior to its expiration point while the short term option is sold with the expectation that the stock will remain below the same point in the near term, prior to the short term expiration date. So, this strategy takes advantage of a stagnant or slow moving up trend. Time decay in the long term option is offset by selling the short term option. The short term option is sold to take maximum benefit from the rate of time decay on the short side. The longer term option also serves as a hedge on the short term position.

The call calendar is similar to the covered call strategy except that it offers better return on risk and requires less trading capital.

**The call calendar spread trade consists of:**

- **Long-term long call**
- **Short-term short call**

It is important to distinguish between the terms used for long and short above. Long term refers to an expiration date sometime in the future while short term refers to expiration date in the nearer future. The long term long call will have more extrinsic value than the short term short call and so the trade will be a debit trade. The long term long call will be the primary trading instrument that generates the profit in the trade and the short term short call will limit the risk by reducing the cost basis of the trade.



## CHAPTER 8 – CALL SPREAD TRADES

### 8.13 Call Calendar Trade Structure

The structure of the trade is as follows:

| Option                | Application                                                                                                                                                                                                                                                              |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Long term long call   | Buy to open an at-the-money or slightly out of the money long term long call option at the ask price                                                                                                                                                                     |
| Short term short call | Sell to open an at-the-money or slightly out-of-the-money short term short call option at the same strike price as the long term call option. The expiration month will be much closer to the current date for the short term call option than the long term call option |

### 8.14 Call Calendar Spread Trade Example

In order to understand this let's structure a call calendar spread trade from the two option chains below:

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

| CALLS           |       |     |       |       |        |               |            | PUTS           |       |      |       |       |        |               |
|-----------------|-------|-----|-------|-------|--------|---------------|------------|----------------|-------|------|-------|-------|--------|---------------|
| Symbol          | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol         | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| SEPTEMBER CALLS |       |     |       |       |        |               | XYZ @20.04 | SEPTEMBER PUTS |       |      |       |       |        |               |
| XYZIW           | 4.700 | 0   | 4.500 | 4.700 | 34     | 1,642         | 17.50      | XYZUW          | 1.200 | 0    | 1.100 | 1.250 | 52     | 1,209         |
| XYZID           | 3.000 | 0   | 3.000 | 3.200 | 432    | 1,821         | 20.00      | XYZUD          | 2.200 | -0.1 | 2.100 | 2.200 | 324    | 1,529         |
| XYZIX           | 1.900 | 0   | 1.900 | 2.050 | 721    | 812           | 22.50      | XYZUX          | 3.50  | +0.1 | 3.400 | 3.500 | 132    | 714           |
| XYZIE           | 1.250 | 0   | 1.150 | 1.250 | 14     | 82            | 25.00      | XYZUE          | 5.400 | 0    | 5.100 | 5.400 | 31     | 241           |

## CHAPTER 8 – CALL SPREAD TRADES

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For the purposes of this example let's consider June to be the current month. We could perform a call calendar spread trade on either the strike 20 (at-the-money) or strike 22.50 (out-of-the-money) call options. The same strategy will be applied in both cases but if we execute the trade on the strike 22.50 call options our risk will be slightly lower and let's assume based on our technical and fundamental analysis that we are very confident that the stock can exceed \$22.50 prior to September but not before June.

The call calendar spread trade at strike 22.50 will consist of buying the September 22.50 call option at the ask price and selling the June 22.50 call option at the bid price.

➔ **Purchase September long call at strike 22.50 ask price for \$2.05/share debit**

➔ **Sell June short call at strike 22.50 bid price for \$0.45/share credit**

The result of these two transactions will be a net debit to your account. This net debit will be the difference between the September long call option debit and the June short call option credit.

➔ **Net debit/share = Risk = \$2.05 - \$0.45 = \$1.60**

The reward in this case is calculated slightly differently to the other spread trades. The potential reward can be determined if and when the short term option expires worthless. If you subtract the net debit from the bid value of the long term option you arrive with a potential reward.

➔ **If short term option expires worthless and stock remains stagnant, Gain = \$1.90 - \$1.60 = \$0.30**

If stock is a little more bullish you can continue to short options against the long position.

### ***8.15 Call Calendar Primary & Secondary Exit Points***

As in all other trades mentioned the primary exit point will control greed. For the call calendar spread trade a primary exit point can be defined when the short term call option expires worthless. Assuming the stock remains stagnant the long term call option can be closed for a profit. If the trend is slightly bullish then you can continue to short options against the long term long call option. Alternatively you can set your primary exit point as a % net gain which is up to you to decide upon.

The secondary exit point is pre-defined and will control the emotion of fear. It is essential in generating consistent profits. Again it is your decision what % loss you are going to define prior to trade execution. Alternatively you can adjust the trade to a different spread trade in order to maintain profits. This is easily accomplished if you

## CHAPTER 8 – CALL SPREAD TRADES

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understand the options trading instruments. For instance, it could be converted to a bear call in a down-trending market.

This trade is somewhat more complex than the strategies considered to this point and requires more maintenance as a result.

### ***8.16 Call Calendar Spread Trade Summary***

The call calendar spread trade is a debit trade. The long call is the primary trading instrument that generates the profits in the trade. The short call limits risk. The trade takes advantage of stagnant or slightly bullish trends.

| <b>Open Position</b>                                                                                                                                                                                                | <b>Primary Exit Point &amp; Adjustment</b>                                                                                                                                                                                                                                                                                                                                                    | <b>Secondary Exit Point &amp; Adjustment</b>                                                                                                                                                                                |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Buy an at-the-money or just out-of-the-money long call option</li><li>• Sell a short call option at the same strike price but with expiration date within 30 days</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• If trend is stagnant decide that you want to capture the entire credit from the short call expiration</li><li>• If trend is slightly bullish you can continue to short call options against the long term long call option</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event of trend change.</li><li>• Alternatively pre-define what trade adjustments you will make to maintain profit potential</li></ul> |

Always make sure to purchase the same number of long call contracts as short call contracts sold so you will not risk opening naked call positions through selling the short call without protecting the position through the long call option.

### ***8.17 Call Spread Trades Summary***

The call spread trades can be used to profit in the stock market irrespective of the market direction. If you have a thorough understanding of the trading instruments then you can adjust your trade to the new trend should your technical analysis validate that a trend change has occurred. When you become skilled at adjusting to trend changes, you are more likely to maintain profits.

## CHAPTER 9 – PUT SPREAD TRADES

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### 9.1 Introduction

This section will outline put spread trade strategies. Application of these strategies does not involve stock ownership and hence requires less capital investment than the collar trade strategy. If you are relatively inexperienced in trading options it is advised that you gain a thorough understanding of the collar trade prior to executing the strategies outlined in this section. Correct application of these trades can be used on their own or in conjunction with collar trades to allow you profit two-fold, once with the collar trade and once through execution of put spread trade strategies.

The put spread trades outlined in this section will show you how to profit in bullish, bearish and stagnant market conditions.

### 9.2 Bear Put Spread Trade

The bear put spread trade is a bearish strategy that requires a down-trending market to generate profits. It is emphasized that this means a bullish or stagnant market will work against the trade. Similarly to other spread trades, it will require more than a single trading instrument.

**The bear put spread trade consists of:**

- **Long put**
- **Short put**

The long put is the primary trading instrument as it will generate the profit in the trade and the short put will reduce the cost basis or risk in the trade. The same expiration month is used for both long and short puts.

This trade is a debit trade since the cost of the long put will exceed the credit received for the short put. It is generally recommended that you initiate the trade with at least 60 days of time value prior to the expiration date of the puts.

### 9.3 Bear Put Trade structure

The structure of the trade is as follows:

| Option    | Application                                                                                                             |
|-----------|-------------------------------------------------------------------------------------------------------------------------|
|           |                                                                                                                         |
| Long put  | Buy to open at-the-money or slightly out-of-the-money long put option at the ask price                                  |
| Short put | Sell to open out-of-the-money short put option at the bid price one or two strike prices lower than the long put option |

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### 9.4 Bear Put Spread Trade Example

In order to understand this let's structure a bear put spread trade from the option chain below:

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |            |           |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

This is the same option chain as seen in the call spread trades strategies. It can be seen, as previously shown, that XYZ is trading at \$20.04. In order to execute a bear put spread trade we are only interested in the put options on the right hand side. The stock is currently trading close to the strike 20 put so it is effectively at-the-money. This will define the point where you will purchase your long put option. So, assuming a bearish sentiment, a bear put spread trade would consist of the following trade executions:

➔ **Purchase long put at strike 20 ask price for \$0.85/share debit**

You can see that the bid price for the strike 17.50 put is \$0.25/share. Selling this put will reduce your cost basis and will also limit your profit potential. This means if the stock falls below \$17.50 you have entered a contract by which you agree to buy the stock at \$17.50 (i.e. you have extended the put buyer the right to sell the stock at \$17.50 should it fall below that value and for that you have received a credit).

➔ **Sell short put at strike 17.50 bid price for \$0.25/share credit**

Now you will want to determine the net debit from this transaction which is the credit from the short put subtracted from the debit from the long put.

➔ **Net debit/share = Risk = \$0.85 - \$0.25 = \$0.60**

The gain/share for this transaction is calculated by subtracting the net debit from the difference between the strike prices. This is because the long put only makes money when the stock is less than \$20 (the long put strike price) and by selling the short put at a strike of 17.50 you will not be making money below \$17.50.

➔ **Max gain/share = (\$20.00 - \$17.50) - \$0.60 = \$1.90**

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### 9.5 *Bear Put Primary & Secondary Exit Points*

As with every trade you enter you must first define your exit points. Like other debit trades your primary exit point will set a return on investment value that is the point at which you will close the trade and hence control your greed. Your secondary exit point should be well-defined also and is critical to maintaining consistent profits or limiting losses by controlling fear. It is up to you to decide what percentage of your investment you are willing to risk and what percentage return you wish to obtain.

If there is trend change from bearish to bullish or from bearish to stagnant you can adjust your bear put to a different spread trade. You will have to validate the trend change through your technical analysis indicators and your trend lines.

In the case of the bear put you would adjust the trade to a bull put or a put calendar as shown in the sections below.

### 9.6 *Bear Put Spread Trade Summary*

The bear put spread trade is a debit trade and the long put is the primary trading instrument that generates the profits in the trade.

| Open Position                                                                                                                                                                                                             | Primary Exit Point & Adjustment                                                                                                                                                                                                    | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                           |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Purchase at-the-money or just out-of-the-money long put option</li><li>• Sell out-of-the-money short put option one or two strike prices lower than the long put option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Gain/share will be difference between strike prices – net debit</li></ul> | <ul style="list-style-type: none"><li>• Your net debit will be the difference between long put debit and short put credit</li><li>• Decide on % loss you are willing to accept in event of trend change</li><li>• If you wish to adjust trade, you can convert it to a bull put or a put calendar</li></ul> |

Always make sure to purchase the same number of long put contracts as short put contracts sold so you will not risk opening naked put positions by selling the short put without protecting the position through the long put option.

It is also noted that selling the out-of-the-money put option offsets time value decay in the higher strike long put position. This is a major advantage over simply buying a long put option.

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### 9.7 *Bull Put Spread Trade*

The bull put spread trade is a bullish strategy that requires a stagnant or up-trending market to generate profits. It is emphasized that this means a bearish market will work against the trade and time decay will help make the trade profitable. Similarly to other spread trades it will require more than a single trading instrument.

**The bull put spread trade consists of:**

- **Short put**
- **Long put**

The short put is the primary trading instrument as it will generate the profit in the trade and the long put will limit the risk in the trade. The same expiration month is used for both long and short puts.

This trade is a credit trade since the cost of the short put will exceed the debit received for the long put. It is generally recommended that you initiate the trade with no more than 45 days of time value prior to the expiration date of the puts.

The bull put can be used over a longer term, even as a LEAPS bull put. In this case there will be considerably more time value associated with the options. Assuming the stock trends in a bullish or stagnant manner up to expiration point this can increase the profit potential of the trade. However, the downside is that the risk in the trade is assumed for a longer period of time.

### 9.8 *Bull Put Trade structure*

The structure of the trade is as follows:

| Option    | Application                                                                                                            |
|-----------|------------------------------------------------------------------------------------------------------------------------|
|           |                                                                                                                        |
| Short put | Sell to open out-of-the-money or at-the-money short put option at the bid price                                        |
| Long Put  | Buy to open out-of-the-money long put option at the ask price one or two strike prices lower than the short put option |

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### 9.9 Bull Put Spread Trade Example

In order to understand this let's structure a bull put spread trade from the option chain below:

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |            |           |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

As in the case of the bear put spread trade example can see that XYZ is trading at \$20.04. Let's assume based on your technical analysis that you believe support for XYZ is at \$20 and you fully expect it to remain above this level prior to expiration.

In order to execute a bull put spread trade we are only interested in the put options on the right hand side just as we were in the bear put spread trade. The stock is currently trading close to the strike 20 call so it is still effectively at-the-money. This will define the point where you will short your put option.

➔ **Sell short put at strike 20.00 bid price for \$0.70/share credit**

In receiving this \$0.70/share credit you are entering a contract whereby you agree to purchase the stock at \$20/share if the stock trades below that value up until the options cease trading on the expiration date. The other side of this agreement is the put purchaser has bought the right to sell the stock at \$20/share if the stock trades below that value up until expiration date.

In order to limit your risk on the trade you will want to purchase the strike 17.50 put.

➔ **Buy to open long put at strike 17.50 ask price for \$0.30/share debit**

By entering this trade you are ensuring that should the stock trade below \$17.50 you have the right to sell the shares at \$17.50 prior to expiration date.

The result of these two transactions will be a credit to your account and will be the difference between the credit for the short put and the debit for the long put. The fact that this is a credit trade means that you are not spending any of your own money to initiate the trade.

➔ **Net credit/share = Maximum Gain = \$0.70 - \$0.30 = \$0.40**



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The maximum risk per share is calculated by subtracting the net credit per share from the difference in strike prices

➔ **Maximum Risk/share** =  $(\$20.00 - \$17.50) - \$0.40 = \$2.10$

When you attempt to execute this trade your broker will require that you have enough trading capital available prior to the execution. This is usually done automatically in order to prevent you from entering positions in which you are not capable of covering should the need arise.

### ***9.10 Bull Put Primary & Secondary Exit Points***

In this trade your primary exit point is to capture the entire credit from initiating the trade when the options cease trading at the close of business on the third Friday of June. This will be realized if the trend is stagnant or bullish. Alternatively you could set a percentage target at which you would exit the trade by buying back the short put option and selling the long put option. If you follow the latter strategy you will incur the cost of commissions to close the trade whereas if you simply let the options expire you will only pay commissions to enter the trade.

You must decide what percentage loss, if any, you are willing to accept as your secondary exit point. You could determine that the breakeven point is the time when you wish to exit the trade. This is the point where the stock price would equal the difference between the short put strike price and the net credit for the trade.

Another strategy for your secondary exit point would be convert the bull put spread trade to a bear put spread trade in the event of the trend turning bearish as validated by technical analysis indicators and trend lines. If this were the case and the stock trended down below your breakeven point for example you would maintain the long put position at strike 17.50 and sell the strike 15 put. The new short put position would lower your cost basis for the trade and potentially turn a losing trade into a winning trade. It should be noted however that if this trade is executed with only 45 days left to expiration then there will be very little time value associated with the new lower strike short put. As a result the breakeven point exit strategy is most likely the one that should be adhered to. However, if you have executed a long term bull put this trade adjustment will be valid and will likely be worth executing.

Your secondary exit point should be well-defined also and is critical to maintaining consistent profits or limiting losses by controlling fear. It is up to you to decide what percentage of your investment you are willing to risk and what percentage return you wish to obtain.

For the bear put trade considered in the first section the adjustment in the event of the trend turning bullish would involve maintaining the long put at strike 20 and selling the

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strike 22.50 put option. You should be aware that the potential does exist to turn losing positions into winning positions by adjusting your trades to the current trend to maintain profitability.

### 9.11 Bull Put Spread Trade Summary

The bull put spread trade is a credit trade and the short put is the primary trading instrument that generates the profits in the trade.

| Open Position                                                                                                                                                                                                                 | Primary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                       | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell out-of-the-money or at-the-money short put option at the bid price</li><li>• Purchase out-of-the-money long put option one or two strike prices below the short option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point or decide that you want to capture the entire credit as profit by allowing the options expire</li><li>• Maximum gain/share will be the net credit that is the difference between the short put credit and the long put debit</li></ul> | <ul style="list-style-type: none"><li>• Maximum risk will be the net credit subtracted from the difference between the short put strike price and the long put strike price</li><li>• Decide on % loss you are willing to accept in event of trend change. When the stock trends down to the equivalent price of the short put strike price - the net credit, this is your breakeven point.</li><li>• If you wish to adjust trade, you can convert it to a bear put or a put calendar</li><li>• You could also take assignment on the short put if it goes in the money. You would then own the stock. Now you could add a long put and a short call and convert to a collar trade.</li></ul> |

Always make sure to purchase the same number of long put contracts as short put contracts sold so you will not risk opening naked put positions by selling the short put without protecting the position through the long put option.

### ***9.12 Put Calendar Spread Trade***

A put calendar spread trade is a neutral time spread using puts. A put calendar spread trade is often used less frequently than a call calendar spread trade. It is used if a decline in stock is expected or a greater return on risk could be generated compared to a call calendar spread trade. Unlike the bear put and bull put spread trades that involved buying and selling different strike prices with the same expiration month, this strategy involves buying and selling the same strike price with different expiration months.

The long term option is purchased with the expectation that the stock will trend downwards prior to its expiration point while the short term option is sold with the expectation that the stock will remain above the same point in the near term, prior to the short term expiration date. So, this strategy takes advantage of a stagnant or slow moving trend. Time decay in the long term option is offset by selling the short term option. The short term option is sold to take maximum benefit from the rate of time decay on the short side. The longer term option also serves as a hedge on the short term position. As stated the trade is a horizontal trade.

The put calendar could also be combined with the bear put to diagonalize the trade. This would mean buying a longer term higher strike put and selling a short term lower strike put and would take advantage of a slightly bearish trend.

**The put calendar spread trade consists of:**

- **Long-term long put**
- **Short-term short put**

As in the example for the call calendar spread trade, long-term refers to an expiration date sometime in the future while short-term refers to expiration date in the nearer future. The long term long put will have more extrinsic value than the short term short put and so the trade will be a debit trade. The long term long put will be the primary trading instrument that generates the profit in the trade and the short term short put will limit the risk by reducing the cost basis of the trade.

## CHAPTER 9 – PUT SPREAD TRADES

### 9.13 Put Calendar Trade Structure

The structure of the trade is as follows:

| Option               | Application                                                                                                                                                                                                                                                          |
|----------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Long term long put   | Buy to open an at-the-money or slightly out of the money long term long put option at the ask price                                                                                                                                                                  |
| Short term short put | Sell to open an at-the-money or slightly out-of-the-money short term short put option at the same strike price as the long term put option. The expiration month will be much closer to the current date for the short term put option than the long term put option |

### 9.14 Calendar Spread Trade Example

In order to understand this let's structure a put calendar spread trade from the two option chains below:

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |            |           |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

| CALLS           |       |     |       |       |        |               |            | PUTS           |       |      |       |       |        |               |
|-----------------|-------|-----|-------|-------|--------|---------------|------------|----------------|-------|------|-------|-------|--------|---------------|
| Symbol          | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol         | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| SEPTEMBER CALLS |       |     |       |       |        |               | XYZ @20.04 | SEPTEMBER PUTS |       |      |       |       |        |               |
|                 |       |     |       |       |        |               |            |                |       |      |       |       |        |               |
| XYZIW           | 4.700 | 0   | 4.500 | 4.700 | 34     | 1,642         | 17.50      | XYZUW          | 1.200 | 0    | 1.100 | 1.250 | 52     | 1,209         |
| XYZID           | 3.000 | 0   | 3.000 | 3.200 | 432    | 1821          | 20.00      | XYZUD          | 2.200 | -0.1 | 2.100 | 2.200 | 324    | 1,529         |
| XYZIX           | 1.900 | 0   | 1.900 | 2.050 | 721    | 812           | 22.50      | XYZUX          | 3.50  | +0.1 | 3.400 | 3.500 | 132    | 714           |
| XYZIE           | 1.250 | 0   | 1.150 | 1.250 | 14     | 82            | 25.00      | XYZUE          | 5.400 | 0    | 5.100 | 5.400 | 31     | 241           |

## CHAPTER 9 – PUT SPREAD TRADES

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Let's consider June to be the current month. We could perform a put calendar spread trade on either the strike 20 (at-the-money) or strike 17.50 (out-of-the-money) put options. The same strategy could be applied in both cases but if we execute the trade on the strike 17.50 put options our credit will be just \$0.25 for the short term put so let's structure the trade with the strike 20 put options. Based on our technical and fundamental analysis, we are confident that the stock can decrease below \$20.00 prior to September but not before June.

The put calendar spread trade at strike 20 will consist of buying the September 20 put option at the ask price and selling the June 20 put option at the bid price.

➔ **Purchase September long put at strike 20 ask price for \$2.20/share debit**

➔ **Sell June short call at strike 20 bid price for \$0.70/share credit**

The result of these two transactions will be a net debit to your account. This net debit will be the difference between the September long put option debit and the June short put option credit.

➔ **Net debit/share = Risk = \$2.20 - \$0.70 = \$1.50**

The reward in this case is calculated slightly differently to the other spread trades. The potential reward can be determined if and when the short term option expires worthless. If you subtract the net debit from the bid value of the long term option you arrive with a potential reward.

➔ **If short term option expires worthless and stock remains stagnant, Gain = \$2.10 - \$1.50 = \$0.60**

If stock is a little more bearish you can continue to short options against the long position and hence continue to reduce risk. By structuring the trade in this way you have created a diagonal application of the spread trade.

### ***9.15 Put Calendar Primary & Secondary Exit Points***

For the put calendar spread trade, a primary exit point can be defined when the short term put option expires worthless. Assuming the stock remains stagnant, the long term put option can be closed for a profit. This is a horizontal execution of the trade. If the trend is slightly bearish then you can continue to short options against the long term long put option up to the expiration date of the long option. Alternatively you can set your primary exit point as a % net gain which is up to you to decide upon.

The secondary exit point is pre-defined and will control fear in your trading. It is essential in generating consistent profits. Again it is your decision what % loss you are

## CHAPTER 9 – PUT SPREAD TRADES

going to define prior to trade execution. Alternatively you can adjust the trade to a different spread trade in order to maintain profits. This is easily accomplished if you understand the options trading instruments. For instance, it could be converted to a bear put in a down-trending market to diagonalize the trade.

This trade is somewhat more complex than the strategies considered to this point and requires more maintenance as a result.

### 9.16 Put Calendar Spread Trade Summary

The put calendar spread trade is a debit trade. The long put is the primary trading instrument that generates the profits in the trade. The short put limits risk. The trade takes advantage of stagnant or slightly bearish trends.

| Open Position                                                                                                                                                                                                                    | Primary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                                                                                             | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Buy an at-the-money or just out-of-the-money long put option 3→6 months out</li><li>• Sell a short put option at the same strike price but with expiration date within 30 days</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• If trend is stagnant decide that you want to capture the entire credit from the short put expiration</li><li>• If trend is slightly bearish you can continue to short put options against the long term put option. If you short lower strike price puts you will diagonalize the trade.</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event of trend change.</li><li>• Alternatively pre-define what trade adjustments you will make to maintain profit potential. Adjustment will be done if trend is very bullish or bearish as confirmed and validated by technical indicators.</li><li>• A bullish adjustment could be to a bull put spread trade.</li><li>• A bearish adjustment could be to a bear put spread trade or alternatively to take short put assignment and own the underlying stock.</li></ul> |

Always make sure to purchase the same number of long put contracts as short put contracts sold so you will not risk opening naked put positions through selling the short put without protecting the position through the long put option.

### ***9.17 Put Spread Trades Summary***

The put spread trades can be used to profit in the stock market irrespective of the market direction. If you have a thorough understanding of the trading instruments then you can adjust your trade to the new trend should your technical analysis validate that a trend change has occurred. When you become skilled at adjusting to trend changes, you are more likely to maintain profits.

## CHAPTER 10 – COMBINATION TRADES

### 10.1 Introduction

In this section we will look at combination trades. These trades differ from spread trades because two options are purchased instead of buying one option and selling another. When spread trading we were able to lower risk by shorting an option. In a combination trade the net debit and hence the risk will be larger than a spread trade because you have to purchase both options.

The two trades we will look at are the straddle and strangle. In both of these trades the risk is limited to the net debit of purchasing the long positions but the reward is potentially unlimited, unlike a spread trade where the maximum gain is limited.

### 10.2 Straddle Trade

The straddle is neither a bullish nor a bearish strategy. When entering this trade you do not care which way the market moves. All that is required is a significant move in either direction to profit in the trade.

**The straddle trade consists of two trading instruments:**

- **Long call**
- **Long put**

Entering a straddle trade requires purchasing the same number of put and call contracts for the same period of time at the same strike price.

### 10.3 Straddle Trade Structure

The structure of the trade is as follows:

| Option    | Application                                                |
|-----------|------------------------------------------------------------|
| Long call | Buy to open at-the-money long call option at the ask price |
| Long put  | Buy to open at-the-money long put option at the ask price  |

Since both options are at-the-money you will be buying mostly extrinsic value. You should only enter this trade during times of volatility such as earnings season. This is an excellent strategy to employ when you don't know which way a stock will move but are confident that the move will be strong in either direction.



## CHAPTER 10 – COMBINATION TRADES

If the stock stays flat both long options will be subject to time decay and will lose value. The trade is best entered when implied volatility is low and there is an expectation of an increase in volatility.

### 10.4 Straddle Trade Example

Let's structure a straddle trade from the options chain below:

| CALLS      |       |     |       |       |        |               |            | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike     | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ @20.04 | JUNE PUTS |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50      | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00      | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50      | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00      | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

From this options chain we can see that XYZ is trading at \$20.04. In order to execute a straddle trade we are interested in the call options on the left hand side and the put options on the right hand side. The stock is currently trading close to the strike 20 call and strike 20 put so it is effectively at-the-money. This will define the point where you will purchase both long call and long put options.

➔ Purchase long call at strike 20 ask price for \$1.55/share debit

➔ Purchase long put at strike 20 ask price for \$0.85/share debit

Now you will want to determine the net debit from this transaction which is the debit from purchasing the long call in addition to the debit from purchasing the long put.

➔ Net debit/share = Risk = \$1.55 + \$0.85 = \$2.40

So, the maximum risk in this trade is \$2.40. The worst-case scenario is for the stock to remain flat at \$20.

In order to calculate what the breakeven points to the upside take the strike price and add it to the net debit/share.

➔ Higher breakeven point = \$20 + \$2.40 = \$22.40

The maximum gain in this trade on the upside is unlimited once the stock surpasses the higher breakeven point.

Similarly the lower breakeven point can be calculated as:

➔ Lower breakeven point = \$20 - \$2.40 = \$17.60

## CHAPTER 10 – COMBINATION TRADES

The maximum gain to the downside is also very significant once the stock decreases below the lower breakeven point.

So between \$17.60 and \$22.40 this trade will not make money. Your due diligence will indicate whether you believe the stock will move outside these boundary points prior to options expiration and what profit you intend capturing once it has done so.

### *10.5 Straddle Trade Summary*

The straddle trade should be entered when periods of volatility are expected that could move an individual stock or the stock market strongly in a particular direction irrespective of what that direction is.

The straddle trade is a debit trade and either the long call or the long put can generate profits in the trade provided the underlying stock moves significantly in either direction.

| Open Position                                                                                                                            | Primary Exit Point & Adjustment                                                                                                                                                                                                                                               | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                                                                                                                                                                               |
|------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Purchase at-the-money long call option</li><li>• Purchase at-the-money long put option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Gain/share will be unlimited once stock moves past breakeven points</li><li>• Risk is limited to net debit</li></ul> | <ul style="list-style-type: none"><li>• Your net debit will be the summation of the long call debit and long put debit</li><li>• Decide on % loss you are willing to accept in event stock remains stagnant</li><li>• Potentially convert to bear put, bull put, put calendar, bull call, call calendar or bear call or combination of above to reduce cost basis. This will require a very thorough understanding of the options trading instruments</li></ul> |

## CHAPTER 10 – COMBINATION TRADES

### 10.6 *Strangle Trade*

The strangle trade consists of two trading instruments:

- Long call
- Long put

Entering a strangle trade requires purchasing the same number of put and call contracts for the same period of time at different strike prices.

A strangle trade will usually have a lower net debit and hence lower risk since both purchased options will be out-of-the-money.

Since both long options are out-of-the-money it will require a significant move in stock price for the trade to become profitable. In fact it will require a larger move than in the case of a straddle trade.

### 10.7 *Strangle Trade Structure*

The structure of the trade is as follows:

| Option    | Application                                                    |
|-----------|----------------------------------------------------------------|
| Long call | Buy to open out-of-the-money long call option at the ask price |
| Long put  | Buy to open out-of-the-money long put option at the ask price  |

Since both options are out-of-the-money you will be buying mostly extrinsic value. You should only enter this trade during times of extreme volatility such as earnings season.

If the stock stays flat both long options will be subject to time decay and will lose value. The trade is best entered when implied volatility is low and there is an expectation of an increase in volatility.

## CHAPTER 10 – COMBINATION TRADES

### 10.8 Strangle Trade Example

Let's structure a straddle trade from the option chain below:

| CALLS      |       |     |       |       |        |               |               | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|---------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike        | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | XYZ<br>@20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |               |           |       |      |       |       |        |               |
| XYZFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50         | XYZRW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| XYZFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00         | XYZRD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| XYZFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50         | XYZRX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| XYZFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00         | XYZRE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

In order to execute a strangle trade we must purchase the same number of out-of-the-money call options and out-of-the-money put options. The stock is currently trading at \$20.04. So in order to initiate a strangle trade we must purchase strike 22.50 call options and strike 17.50 put options.

➔ Purchase long call at strike 22.50 ask price for \$0.50/share debit

➔ Purchase long put at strike 17.50 ask price for \$0.30/share debit

You will want to determine the net debit from this transaction which is the debit from purchasing the long call in addition to the debit from purchasing the long put.

➔ Net debit/share = Risk = \$0.50 + \$0.30 = \$0.80

So, the maximum risk in this trade is \$0.80. The first thing to note is that this is significantly less than the net debit when initiating a straddle trade. However, the stock must move considerably more for the strangle trade to realize a profit.

In order to calculate the breakeven points to the upside, take the call strike price and add it to the net debit/share.

➔ Higher breakeven point = \$22.50 + \$0.80 = \$23.30

The maximum gain in this trade on the upside is unlimited once the stock surpasses the higher breakeven point.

Similarly the lower breakeven point can be calculated by subtracting the net debit from the put strike price:

➔ Lower breakeven point = \$17.50 - \$0.80 = \$16.70

The maximum gain to the downside is also very significant once the stock decreases below the lower breakeven point.

## CHAPTER 10 – COMBINATION TRADES

So between \$16.70 and \$23.30 this trade will not make money. Your due diligence will indicate whether you believe the stock will move outside these boundary points prior to options expiration and what profit you intend capturing once it has done so.

### ***10.9 Strangle Trade Summary***

The strangle trade should be entered when periods of volatility are expected that could move an individual stock or the stock market strongly in a particular direction irrespective of what that direction is.

The strangle trade is a debit trade and either the long call or the long put can generate profits in the trade provided the underlying stock moves significantly in either direction.

| <b>Open Position</b>                                                                                                                             | <b>Primary Exit Point &amp; Adjustment</b>                                                                                                                                                                                                                                                                                                                                                                                                                  | <b>Secondary Exit Point &amp; Adjustment</b>                                                                                                                                                                                                                                                                                                                                                                                                                   |
|--------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Purchase out-of-the-money long call option</li><li>• Purchase out-of-the-money long put option</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Gain/share will be unlimited once stock moves past breakeven points</li><li>• Risk is limited to net debit. This will be lower than the net debit required to initiate a straddle trade since both long options are out-of-the-money and hence will be comprised 100% of extrinsic value</li></ul> | <ul style="list-style-type: none"><li>• Your net debit will be the summation of the long call debit and long put debit</li><li>• Decide on % loss you are willing to accept in event stock remains stagnant</li><li>• Potentially convert to bear put, bull put, put calendar bull call, call calendar or bear call or combination of above to reduce cost basis. This will require a very thorough understanding of the options trading instruments</li></ul> |

### ***10.10 Straddle Or Strangle***

If the stock price is at the strike price of an option chain then the rule of thumb is to enter a straddle trade. If the stock price is between strike prices of an option chain then a strangle trade is recommended.

# CHAPTER 11 – RATIO BACKSPREADS

## ***11.1 Introduction***

Ratio backspreads comprise three or more option positions. We will look at the call ratio backspread that can generate theoretically unlimited profits if the stock moves strongly to the upside but can also generate a comparatively small return in the event the stock declines in price. We will also look at the put ratio backspread that can generate substantial profits if the stock moves aggressively to the downside but can also generate a minimal return if the stock rises in value.

These strategies comprise both purchasing and selling different numbers of long and short option contract positions and as a result are considered complex strategies that should be attempted only when you thoroughly understand the options trading instruments.

## ***11.2 Call Ratio Backspread Trade***

The call ratio backspread has limited downside risk and unlimited upside potential. As a result, the strategy should be employed when a strong move to the upside is expected but you want protection against downward movement.

In order to guarantee that the trade still generates a return if the stock falls in value, the trade should be established for a credit.

**The call ratio backspread comprises:**

- **Short Call**
- **Long Call**

The trade involves buying and selling different numbers of call contracts at different strike prices for the same time period.

## ***11.3 Call Ratio Backspread Trade Structure***

The call ratio backspread involves selling short a call option at one strike price and simultaneously buying multiple higher strike calls. The ratio between short and long calls is typically 1:2 (1 short call sold for every 2 purchased long calls).

If you are highly bullish you could structure the trade with a 1:3 ratio. In this case profits will accrue faster when the stock rises because 1 long call is offsetting the loss in the short call and the remaining two calls are generating pure profit.

The higher the ratio the faster the trade becomes profitable. Conversely with lower ratios, the greater the stock must move in order to become profitable. It is recommended that ratios less than 2:3 be avoided.

## CHAPTER 11 – RATIO BACKSPREADS

The structure of the call ratio backspread trade is as follows:

| Option        | Application                                                                                                       |
|---------------|-------------------------------------------------------------------------------------------------------------------|
| Short call(s) | Sell to open at-the-money short call(s) option(s) at the bid price                                                |
| Long calls    | Buy to open multiple long call options at the ask price one or two strikes above short call option's strike price |

Since the long call options will be out-of-the-money, you will be purchasing 100% extrinsic value. The short call option(s) will be at-the-money or slightly in-the-money and will be mostly extrinsic value also.

### 11.4 Call Ratio Backspread Trade Example

Let's do a 1:2 call ratio backspread using the options chain below:

| CALLS      |       |     |       |       |        |               |             | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|-------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike      | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | NVDA @20.04 | JUNE PUTS |       |      |       |       |        |               |
| UVAFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50       | UVARW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| UVAFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00       | UWARD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| UVAFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50       | UVARX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| UVAFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00       | UVA RE    | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

Let's consider that we are very bullish based on our due diligence and we want to execute a 20-25 call ratio backspread.

The stock is currently trading at \$20.04, the 20 strike call is trading at \$1.45 bid and \$1.55 ask and the 25 strike call is trading at \$0.05 bid and \$0.20 ask.

When entering this trade your broker will probably want you to purchase the long call options prior to selling the short call option. If you were to sell the short call option prior to purchasing the long call options and without owning the stock you would have initiated a naked call trade. As mentioned previously brokers often have strict capital requirements when naked call trades are initiated because of the theoretically unlimited risks involved if the stock keeps rising.

➔ Purchase 2 long calls at strike 25 ask price for \$0.20/share debit

➔ Sell 1 short call at strike 20 bid price for \$1.45/share credit

## CHAPTER 11 – RATIO BACKSPREADS

Now you will want to determine the net credit from this transaction which is the debit from purchasing the long calls subtracted from the credit from selling the short call.

➔ **Net credit** =  $\$1.45 - (\$0.20 \times 2\text{contracts}) = \$1.05$

If the stock now moves to the downside and remains below \$20 prior to options expiration, the credit becomes pure profit.

We will want to calculate the maximum risk in this trade. We first multiply the difference in strike prices by the figure that is used in the short side of the ratio (in this case a 1:2 ratio was used so we multiply by 1). We then subtract the net credit from the result of this calculation.

➔ **Maximum Risk** =  $[(\$25 - \$20) \times 1] - \$1.05 = \$3.95$

We will also want to calculate the lower and higher breakeven points.

The lower breakeven point is calculated by dividing the credit by the figure that is used in the short side of the ratio and then adding the result to the lower strike price.

➔ **Lower breakeven point** =  $(\$1.05/1) + \$20 = \$21.05$

The higher breakeven point is calculated by dividing the maximum risk by the difference between in the number of long and short calls (a 1:2 ratio has a difference of 1, a 1:3 ratio has a difference of 2) and adding to the *higher* strike price.

➔ **Higher breakeven point** =  $(\$3.95/1) + \$25 = \$28.95$

If the stock rallies slightly and then stagnates between the lower and higher breakeven points, the trade will lose money. So the stock must rally above \$28.95 for this trade to become profitable on the upside. As you can see this requires a considerable upswing and so this trade should only be initiated when you are very bullish.

As the spread between the long and short positions increases, the risk in the trade increases since the breakeven points become farther apart. At the same time as the spread increases, more credit is created for entering the trade. The spread should be kept as narrow as possible and for as long a time as possible to give the stock the most opportunity to move strongly to the upside and make the trade profitable.



## CHAPTER 11 – RATIO BACKSPREADS

### 11.5 Call Ratio Backspread Trade Summary

It is preferable to execute call ratio backspreads during times of lower implied volatility, the trade still counteracts the negative effects of higher volatility better than straddles or strangles. During a period of volatility such as an earnings release you may have seen a stock gap up and expect that the stock will continue to move strongly in this direction and take advantage with a call ratio backspread.

The call ratio backspread trade should be initiated as a credit trade. A minimal return is generated if the stock declines in value while a substantial profit can be generated if the stock moves strongly to the upside.

| Open Position                                                                                                                                                                                                                                                                                                                                     | Primary Exit Point & Adjustment                                                                                                                                                                                                              | Secondary Exit Point & Adjustment                                                                                                                                                                                                                    |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell at-the-money short call option</li><li>• Purchase out-of-the-money long call options one or two strikes above the short call strike price</li><li>• Initiate trade with a 1:2 ratio of short call option to long call options if bullish. If very bullish initiate trade with a 1:3 ratio.</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Gain/share will be unlimited once stock moves past higher breakeven point</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event stock remains stagnant</li><li>• Potentially convert trade. This will require a very thorough understanding of the options trading instruments</li></ul> |

## CHAPTER 11 – RATIO BACKSPREADS

### 11.6 Put Ratio Backspread Trade

The put ratio backspread is a bearish strategy. Substantial profits can be generated if the stock moves strongly down while minimal returns can be generated if the stock rises in value. As a result, the strategy should be employed when a strong move to the downside is expected but you want protection against upward movement.

In order to guarantee that the trade still generates a return if the stock rises in value, the trade should be established for a credit.

**The put ratio backspread comprises:**

- **Short Put**
- **Long Put**

The trade involves buying and selling different numbers of put contracts at different strike prices for the same time period.

### 11.7 Put Ratio Backspread Trade Structure

The put ratio backspread involves selling short a put option at one strike price and simultaneously buying multiple lower strike puts. The ratio between short and long puts is typically 1:2 (1 short put sold for every 2 purchased long puts).

If you are highly bearish you could structure the trade with a 1:3 ratio. In this case profits will accrue faster when the stock falls because 1 long put is offsetting the loss in the short put and the remaining two puts are generating pure profit.

The higher the ratio the faster the trade becomes profitable. Conversely with lower ratios, the greater the stock must move in order to become profitable. It is recommended that ratios less than 2:3 be avoided.

The structure of the put ratio backspread trade is as follows:

| Option       | Application                                                                                                     |
|--------------|-----------------------------------------------------------------------------------------------------------------|
|              |                                                                                                                 |
| Short put(s) | Sell to open at-the-money short put(s) option(s) at the bid price                                               |
| Long puts    | Buy to open multiple long put options at the ask price one or two strikes below short put option's strike price |

Since the long put options will be out-of-the-money, you will be purchasing 100% extrinsic value. The short put option(s) will be at-the-money or slightly in-the-money and will be mostly extrinsic value also.

## CHAPTER 11 – RATIO BACKSPREADS

### 11.8 Put Ratio Backspread Trade Example

Let's do a 1:2 put ratio backspread using the options chain below:

| CALLS      |       |     |       |       |        |               |             | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|-------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike      | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | NVDA @20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |             |           |       |      |       |       |        |               |
| UVAFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50       | UVARW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| UVAFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00       | UWARD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| UVAFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50       | UVARX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| UVAFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00       | UVARE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

Let's consider that we are bearish based on our due diligence and we want to execute a 17.50-20 put ratio backspread.

The stock is currently trading at \$20.04, the 20 strike put is trading at \$0.70 bid and \$0.85 ask and the 17.50 strike put is trading at \$0.25 bid and \$0.30 ask.

➔ Purchase 2 long puts at strike 17.50 ask price for \$0.30/share debit

➔ Sell 1 short put at strike 20 bid price for \$0.70/share credit

Now you will want to determine the net credit from this transaction which is the debit from purchasing the long puts subtracted from the credit from selling the short put.

➔ Net credit = \$0.70 – (\$0.30 x 2contracts) = \$0.10

If the stock now moves upwards and remains above \$20 prior to options expiration, the credit becomes pure profit.

We will want to calculate the maximum risk in this trade. We first multiply the difference in strike prices by the figure that is used in the short side of the ratio (in this case a 1:2 ratio was used so we multiply by 1). We then subtract the net credit from the result of this calculation.

➔ Maximum Risk = [(\$20-\$17.50) x 1] – \$0.10 = \$2.40

We will also want to calculate the lower and higher breakeven points.

The higher breakeven point is calculated by dividing the credit by the figure that is used in the short side of the ratio and then subtracting the result from the higher strike price.

➔ Higher breakeven point = \$20 - (\$0.10/1) = \$19.90

## CHAPTER 11 – RATIO BACKSPREADS

The lower breakeven point is calculated by dividing the maximum risk by the difference between in the number of long and short puts (a 1:2 ratio has a difference of 1, a 1:3 ratio has a difference of 2) and subtracting from the *lower* strike price.

➔ **Lower breakeven point = \$17.50 - (\$2.40/1) = \$15.60**

If the stock falls slightly and then stagnates between the lower and higher breakeven points, the trade will lose money. So the stock must fall below \$15.60 for this trade to become profitable on the downside.

As the spread between the long and short positions increases, the risk in the trade increases since the breakeven points become farther apart. At the same time as the spread increases, more credit is created for entering the trade. Although a profit is realized if the stock rises, the put ratio backspread should not be used if an upward trend is anticipated. Other strategies will benefit far more from this type of movement.

### ***11.9 Put Ratio Backspread Trade Summary***

It is preferable to execute put ratio backspreads during times of lower implied volatility. During a period of volatility such as an earnings release you may have seen a stock gap down and expect that the stock will continue to move strongly in this direction and take advantage with a put ratio backspread.

The put ratio backspread trade should be initiated as a credit trade. A minimal return is generated if the stock rises in value while a substantial profit can be generated if the stock moves strongly to the downside.

| <b>Open Position</b>                                                                                                                                                                                                                                                                                                                         | <b>Primary Exit Point &amp; Adjustment</b>                                                                                                                                                                                                  | <b>Secondary Exit Point &amp; Adjustment</b>                                                                                                                                                                                                         |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell at-the-money short put option</li><li>• Purchase out-of-the-money long put options one or two strikes below the short put strike price</li><li>• Initiate trade with a 1:2 ratio of short put option to long put options if bearish. If very bearish initiate trade with a 1:3 ratio.</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Gain/share will be unlimited once stock moves past lower breakeven point</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event stock remains stagnant</li><li>• Potentially convert trade. This will require a very thorough understanding of the options trading instruments</li></ul> |

## CHAPTER 12 – BUTTERFLY SPREADS

### *12.1 Introduction*

Stocks and markets assert themselves in strong directional trends approximately 15% of the time. The rest of the time they tend to form stable or stagnant stock patterns, often building bases prior to the next directional move or trading within a narrow range. Butterfly spreads are complex strategies that can profit from these stable conditions.

Butterfly spreads involve 3 or more options positions. The downside of opening many options positions is the increased commission costs can negatively impact the overall profitability of trades. On the upside, butterfly spreads offer reduced risk exposure than other strategies that can generate consistent cash flow from stagnant stocks such as the covered call strategy.

In this chapter we will look at the call butterfly spread and the put butterfly spread.

### *12.2 Call Butterfly Spread Trade*

A call butterfly spread trade is a combination of a bull call spread trade and a bear call spread trade. The trade is usually entered into for as short a time frame as possible that still offers a good risk to reward ratio. The reason for this is you are expecting the stock to remain somewhat stagnant. If you were to enter the trade prior to earnings there is a much greater probability that the stock could make a strong directional move.

**The call butterfly spread trade is a debit trade that comprises:**

- **Long Calls**
- **Short Calls**

The trade involves buying and selling call contracts at different strike prices for the same time period.

### *12.3 Call Butterfly Spread Trade Structure*

The call butterfly spread trade involves shorting two calls at-the-money and buying one long call option at a higher strike price and one long call option at a lower strike price, ensuring the difference between the strike price of the short calls and the higher and lower strikes is the same.

The lower strike long call is in-the-money and will have most intrinsic value. The short call options are sold at-the-money since they are richest in time value premium. The higher strike long call option is out-of-the-money and its value is entirely extrinsic. The trade is a debit trade.

## CHAPTER 12 – BUTTERFLY SPREADS

The structure of the call butterfly spread trade is as follows:

| Option      | Application                                                                                                                                                                             |
|-------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Short calls | Sell to open at-the-money short call options at the Bid price                                                                                                                           |
| Long calls  | Buy to open long call option at the Ask price one strike above the short call strike price and buy long call option at the Ask price one strike below short call options' strike price. |

If you were slightly bullish you could structure the trade around shorting slightly out-of-the-money calls. And if you were slightly bearish you could structure the trade by shorting slightly in-the-money calls.

When entering this trade your broker will probably want you to purchase the long call options prior to selling the short call options. If you were to sell the short call options prior to purchasing the long call options and without owning the stock you would have initiated a naked call trade. As mentioned previously brokers often have strict capital requirements when naked call trades are initiated because of the theoretically unlimited risks involved if the stock keeps rising.

### 12.4 Call Butterfly Spread Trade Example

Let's do a call butterfly spread trade using the options chain below:

| CALLS      |       |     |       |       |        |               |             | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|-------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike      | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | NVDA @20.04 | JUNE PUTS |       |      |       |       |        |               |
| UVAFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50       | UVARW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| UVAFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00       | UWARD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| UVAFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50       | UVARX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| UVAFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00       | UVARE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

Let's consider that we expect the stock to remain within a trading range based on our due diligence and we want to execute a 17.50-20-22.50 call butterfly spread.

The stock is currently trading at \$20.04, the 17.50 strike call is trading at \$3.40 bid and \$3.50 ask, the 20 strike call is trading at \$1.45 bid and \$1.55 ask and the 22.50 strike call is trading at \$0.45 bid and \$0.50 ask.

➔ Purchase 1 long call at strike 17.50 ask price for \$3.50/share debit

➔ Purchase 1 long call at strike 22.50 ask price for \$0.50/share debit

## CHAPTER 12 – BUTTERFLY SPREADS

➔ **Sell 2 short calls at strike 20 bid price for \$1.45/share credit**

Now you will want to determine the maximum risk in the trade which is the sum of the credits from the short calls subtracted from the sum of the debits from long call purchases.

$$\text{Maximum Risk} = \$3.50 + \$0.50 - (2 \times \$1.45) = \$1.10$$

To determine the maximum gain achievable in this trade subtract the maximum risk from the difference between the middle strike sold and either long call strike.

$$\text{Maximum Gain} = \$2.50 - \$1.10 = \$1.40$$

The lower breakeven point can be calculated as the sum of the lower strike price and the maximum risk.

$$\text{Lower Breakeven Point} = \$17.50 + \$1.10 = \$18.60$$

The higher breakeven point can be calculated as the maximum risk subtracted from the higher strike price.

$$\text{Higher Breakeven Point} = \$22.50 - \$1.10 = \$21.40$$

As long as the stock is trading between the two breakeven points at expiration the trade will be profitable.

So, if the stock is trading at \$19.50/share the profit will be

$$\$19.50 - \$17.50 - \$1.10 = \$0.90$$

And if the stock is trading at \$21 then the profit will be

$$\$22.50 - \$21 - \$1.10 = \$0.40$$

### ***12.5 Call Butterfly Spread Trade Summary***

It is preferable to execute call butterfly spreads when stocks are transitioning from periods of strong directional movement to consolidation. A leading stock will often move up on higher volume due to institutional buying and then trade within a narrow range as it builds a new base before continuing its move upwards again. This trade should be held for short time periods so that there is less time for the stock to breakout and therefore the probability of the trade profiting increases.

This strategy should not be used prior to news events that could cause volatility such as earnings releases. It should not be used on highly volatile stocks either because a breakout could result in losses.

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The call butterfly spread trade should be initiated as a debit trade. Stocks with over-priced premiums due to implied volatilities allow the trade to be entered for lower net debit. You should enter the trade for as short a time period as possible and still maintain a risk to reward ratio of at least 1:1

| Open Position                                                                                                                                                                                                                                                                                                                                                                                        | Primary Exit Point & Adjustment                                                                                                                                                                                                             | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                           |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell 2 at-the-money short call options</li><li>• Purchase 1 out-of-the-money long call option one or two strikes above and 1 long call option one or two strike prices below the short call strike price. Ensure the difference between long and short call strikes is equal.</li><li>• Initiate trade with a risk to reward ratio of at least 1:1</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Calculate maximum risk, maximum gain, lower and higher breakeven points.</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event stock breaks out above higher breakeven point or below lower breakeven point.</li><li>• Potentially convert trade. This will require a very thorough understanding of the options trading instruments</li></ul> |



## CHAPTER 12 – BUTTERFLY SPREADS

### *12.6 Put Butterfly Spread Trade*

A put butterfly spread trade is a combination of a bull put spread trade and a bear put spread trade. The trade is usually entered into for as short a time frame as possible that still offers a good risk to reward ratio. The reason for this is you are expecting the stock to remain somewhat stagnant. If you were to enter the trade prior to earnings there is a much greater probability that the stock could make a strong directional move.

**The put butterfly spread trade is a debit trade that comprises:**

- **Long Puts**
- **Short Puts**

The trade involves buying and selling put contracts at different strike prices for the same time period.

### *12.7 Put Butterfly Spread Trade Structure*

The put butterfly spread trade involves shorting two puts at-the-money, buying one long put option at a higher strike price and one long put option at a lower strike price, ensuring the difference between the strike price of the short puts and the higher and lower strikes is the same.

The higher strike long put is in-the-money and will have most intrinsic value. The short put options are sold at-the-money since they are richest in time value premium. The lower strike long put option is out-of-the-money and its value is entirely extrinsic. The trade is a debit trade.

The structure of the put butterfly spread trade is as follows:

| Option     | Application                                                                                                                                                                         |
|------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Short puts | Sell to open at-the-money short put options at the bid price                                                                                                                        |
| Long puts  | Buy to open long put option at the ask price one strike above the short put strike price and buy long put option at the ask price one strike below short put options' strike price. |

Based on your technical analysis and your outlook for the stock you may want to purchase the long puts greater than one strike above or below the short puts strike price.

When entering this trade your broker will probably want you to purchase the long put options prior to selling the short put options. This will reduce your capital maintenance requirements in your brokerage account.

## CHAPTER 12 – BUTTERFLY SPREADS

### 12.8 Put Butterfly Spread Trade Example

Let's do a put butterfly spread trade using the options chain below:

| CALLS      |       |     |       |       |        |               |             | PUTS      |       |      |       |       |        |               |
|------------|-------|-----|-------|-------|--------|---------------|-------------|-----------|-------|------|-------|-------|--------|---------------|
| Symbol     | Last  | Chg | Bid   | Ask   | Volume | Open Interest | Strike      | Symbol    | Last  | Chg  | Bid   | Ask   | Volume | Open Interest |
| JUNE CALLS |       |     |       |       |        |               | NVDA @20.04 | JUNE PUTS |       |      |       |       |        |               |
|            |       |     |       |       |        |               |             |           |       |      |       |       |        |               |
| UVAFW      | 3.500 | 0   | 3.400 | 3.500 | 34     | 11,752        | 17.50       | UVARW     | 0.300 | 0    | 0.250 | 0.300 | 515    | 5,709         |
| UVAFD      | 1.550 | 0   | 1.450 | 1.550 | 432    | 7,821         | 20.00       | UWARD     | 0.850 | -0.1 | 0.700 | 0.850 | 612    | 6,529         |
| UVAFX      | 0.500 | 0   | 0.450 | 0.500 | 721    | 4,111         | 22.50       | UVARX     | 2.050 | +0.1 | 2.650 | 2.850 | 88     | 714           |
| UVAFE      | 0.100 | 0   | 0.050 | 0.200 | 14     | 1,382         | 25.00       | UVARE     | 4.100 | 0    | 5.000 | 5.300 | 31     | 241           |

Let's consider that we expect the stock to remain within a trading range based on our due diligence and we want to execute a 17.50-20-22.50 put butterfly spread.

The stock is currently trading at \$20.04, the 17.50 strike put is trading at \$0.25 bid and \$0.30 ask, the 20 strike put is trading at \$0.70 bid and \$0.85 ask and the 22.50 strike put is trading at \$2.65 bid and \$2.85 ask.

➔ Purchase 1 long put at strike 17.50 ask price for \$0.30/share debit

➔ Purchase 1 long put at strike 22.50 ask price for \$2.85/share debit

➔ Sell 2 short puts at strike 20 bid price for \$0.85/share credit

Now you will want to determine the maximum risk in the trade which is the sum of the credits from the short puts subtracted from the sum of the debits from long put purchases.

**Maximum Risk = \$0.30 + \$2.85 – (2 x \$0.85) = \$1.45**

To determine the maximum gain achievable in this trade subtract the maximum risk from the difference between the middle strike sold and either long put strike.

**Maximum Gain = \$2.50 - \$1.45 = \$1.05**

The lower breakeven point can be calculated as the sum of the lower strike price and the maximum risk.

**Lower Breakeven Point = \$17.50 + \$1.45 = \$18.95**

The higher breakeven point can be calculated as the maximum risk subtracted from the higher strike price.

**Higher Breakeven Point = \$22.50 - \$1.45 = \$21.05**

## CHAPTER 12 – BUTTERFLY SPREADS

As long as the stock is trading between the two breakeven points at expiration the trade will be profitable.

So, if the stock is trading at \$19.50/share the profit will be

$$\$19.50 - \$17.50 - \$1.45 = \$0.55$$

And if the stock is trading at \$20.50 then the profit will be

$$\$22.50 - \$20.50 - \$1.45 = \$0.55$$

## CHAPTER 12 – BUTTERFLY SPREADS

### 12.9 Put Butterfly Spread Trade Summary

This trade profits during stagnant market conditions. This strategy should not be used prior to news events that could cause volatility such as earnings releases. It should not be used on highly volatile stocks either because a breakout could result in losses.

The put butterfly spread trade should be initiated as a debit trade. Stocks with over priced premiums due to implied volatilities allow the trade to be entered for lower net debit. Signals of decreasing implied volatility are evident when the VIX recedes and Bollinger bands begin to contract (see Technical & Sentimental Analysis chapters).

You should enter the trade for as short a time period as possible and still maintain a risk to reward ratio of at least 1:1

| Open Position                                                                                                                                                                                                                                                                                                                                                                                    | Primary Exit Point & Adjustment                                                                                                                                                                                                             | Secondary Exit Point & Adjustment                                                                                                                                                                                                                                                                           |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Sell 2 at-the-money short put options</li><li>• Purchase 1 out-of-the-money long put option one or two strikes below and 1 long put option one or two strike prices above the short put strike price. Ensure the difference between long and short put strikes is equal.</li><li>• Initiate trade with a risk to reward ratio of at least 1:1.</li></ul> | <ul style="list-style-type: none"><li>• Decide on the percentage return you wish to achieve in the trade and set it as your primary exit point</li><li>• Calculate maximum risk, maximum gain, lower and higher breakeven points.</li></ul> | <ul style="list-style-type: none"><li>• Decide on % loss you are willing to accept in event stock breaks out above higher breakeven point or below lower breakeven point.</li><li>• Potentially convert trade. This will require a very thorough understanding of the options trading instruments</li></ul> |

### ***13.1 Introduction***

Fundamental analysis is a critically important aspect of a successful trading strategy. A strong understanding of company fundamentals will significantly improve your chances of executing trades that will be profitable.

A number of criteria should be followed in order to ascertain whether a company is worth investing in. At the top of that list should be the probability of the company not only surviving but excelling over the long term, at least five years. Companies with a sustainable, competitive advantage will be successful.

A primary indicator of a company's financial health is its earnings. Publicly traded companies release earnings once a quarter. Companies with strong quarterly and yearly earnings growth tend to outperform the market. A common rule of thumb is to pick stocks that have 25% to 50% annual growth rates over the last two to three years. This ensures you don't invest in a company based on a single quarter's results that may be a flash in the pan. The calendar for earnings events can be viewed on many websites including:

- [www.earnings.com](http://www.earnings.com)
- [www.whisperearnings.com](http://www.whisperearnings.com)

Although it may seem obvious it is worth noting that most stocks move in the same direction as the market. Economic indicators released monthly or weekly often impact the direction of the market and should be monitored as part of your strategy, particularly if you are a more active trader searching for short term gains. Certain indicators such as

- **Unemployment numbers**
- **GDP**
- **Consumer confidence numbers**

have greater impact than others and will move the market depending on how they fared versus the consensus figure. The schedule for these events can be found on a number of websites including:

- [www.bloomberg.com](http://www.bloomberg.com)
- [www.cnn.com](http://www.cnn.com)

It is essential also to pay attention to news events and the effect they have on the stock market. For example in times of war defense stocks such as Boeing, Lockheed Martin and Northrop Grumman tend to do well. Precious metals such as gold also have a history of doing well at these times. Prior to Christmas, retail companies traditionally outperform the market. During spring home builders (Home Depot, Lowe's) tend to

outperform the market. Indeed surveys have shown that the market itself has a history of performing better from October through March than from April through September.

### ***13.2 What criteria are used to judge fundamentals for a particular company?***

When considering an investment in a given company the following criteria should be considered:

- **Debt/Equity Ratio**
- **% Shares Held By Institutions**
- **Growth Trends**
- **Management Performance**
- **Market Multiples**
- **Intrinsic Value**

#### ***13.2.1 Debt-to-Equity Ratio***

It is preferable to invest in companies with low corporate debt-to-equity ratios. As mentioned previously earnings releases can precipitate movement in company stock prices. A company with high debt-to-equity ratio could have its earnings per share value negatively impacted during periods of high interest rates. Companies with convertible bonds can also dilute earnings when the bonds convert to shares.

#### ***13.2.2 % Shares Held By Institutions***

Institutional ownership refers to the shares owned by institutions such as mutual funds, pension funds, hedge funds and insurance companies to name just a few. The majority of market trading activity can be attributable to institutions buying and selling shares. They have the capital to significantly impact market movements based on huge demand or supply. Institutions tend to buy stocks that have good long term growth and hence perform detailed research on company fundamentals. During earnings release periods each quarter institutions will buy and sell large blocks of shares that contributes to volatility.

A common rule of thumb is to buy stocks that have at least 40% institutional ownership. It is possible to buy stocks that are “over-owned” by institutions. During the “bubble” period some technology stocks such as Cisco were heavily owned by institutions and this resulted in large volume selling during the subsequent down-trending or bear market. For the most part it takes big demand to move prices up and institutions are the largest source of big demand for stocks.

### 13.2.3 *Growth Trends*

Growth trends are categorized in terms of three parameters

- **Revenue**
- **Net income**
- **Cash Flow**

When researching revenue growth for a company, it should be measured relative to a certain reference or references such as other companies in its industry or relative to the stock market in general, for example the benchmark indices: S&P500, the Dow Jones or the broader based NASDAQ. This will provide a good comparison for how the company is performing relative to its peers.

Net income for a company is the same as net profit. Net profit is the gross sales minus taxes, interest, depreciation and other expenses. These figures will indicate how fast a company's earnings are growing. A company with earnings below that of its industry may indicate a company has rising costs or decreased sales or both.

Cash flow is a measure of a company financial health. Cash flow refers to cash receipts minus cash payments over a period of time. Comparisons with competitor companies will give a good overview of a company's trends over a set period of time.

### 13.2.4 *Management Performance*

Management performance can be measured against the following criteria

- **Return on equity**
- **Return on assets**
- **Return on invested capital**

Return on equity measures how well a company uses re-invested earnings to generate additional earnings. It is used as a general indication of a company's efficiency; in other words, how much profit is it able to generate given the resources provided by its stockholders.

Return on assets is a measure of a company's profitability and is equal to a fiscal year's earnings divided by its total assets expressed as a percentage. Efficient use of assets can be a sign of a good management team.

Return on invested capital measures how effectively a company uses money (borrowed or owned) invested in operations. It is calculated as the net income after taxes divided by total assets minus excess cash minus non-interest bearing liabilities.

Each of these indicators should be used comparatively with respect to competitor

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companies, industry groups or sectors and the overall market to reflect how the management is performing overall.

### **13.2.5      *Market Multiples***

Market multiples considered here include

- **Price/Earnings (P/E) ratio**
- **Price/Sales (P/S) ratio**

Earnings per share growth tends to be more important than P/E ratios or dividends. Companies may have to pay high interest rates to replenish funds paid out in the form of dividends. A couple of days' stock fluctuation can also wipe out annual dividend yields. A low P/E ratio can infer a poor past history for a company. Most stocks sell for what they're worth at the time. Cyclical stocks tend to have lower P/Es. High P/E stocks tend to be more volatile, particularly in the volatile technology area. Stocks with low P/Es are not necessarily cheap bargains. Xerox had a P/E of 100 in 1960 before advancing 3300% in price!

Low P/S figures relative to competitors can be indicative of lower margins or below average sales growth. It is a useful figure to understand to what extent investors/traders value a company and hence are willing to pay for it over and above its revenue.

### **13.2.6      *Intrinsic Value***

Resources are available to calculate intrinsic value of companies. Factors such as the growth rate of initial earnings and discounting future earnings at a given rate can generate net present value of a company's next number of years' earnings. The long term debt is also a factor. These calculations are good indicators however the company's future performance is subject to multiple variable including new products, organizational management changes, strategic decisions and macro-economic events.

The intrinsic value makes a valuation determination (overvalued/undervalued) of intrinsic value per share versus current stock price per share. As mentioned this is only an indication and should be regarded as a helpful indicator rather than a fixed rule. For instance Microsoft has a tendency to trade above its intrinsic per share value and can be theoretically labeled overvalued when in fact its behavior is consistent with its historical price movements and valuations.

Excellent resources for obtaining such information is:

- [www.quicken.com](http://www.quicken.com)
- [www.smartmoney.com](http://www.smartmoney.com)



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In the analysis section for Quicken, go to stock evaluator to compare a company's performance relative to its peers.

### ***13.3 What stock do I select?***

It is advisable to trade securities in an industry with which you are familiar. For example those in the technical area might consider stocks such as Apple, Sandisk, Nokia, AMD, Microsoft, Applied Material and so on.

Consider market trends in your approach to no or low risk trading. Periods of market volatility such as earnings releases, price level and news events should also be considered.

#### ***13.3.1 Research Resources***

You'll likely thrive as an investor if you stick with stocks that show the strongest, most stable growth in profit, revenue, profit margins and return on equity. It is almost too daunting a task for an individual investor to research hundreds of earnings reports. One website that will provide a proprietary Earnings Per Share rating that combines year-over-year earnings growth over the past three to five years with changes in the latest two quarters is listed below:

- [www.investors.com](http://www.investors.com)

It is an excellent resource for obtaining ideas for researching fundamentally solid companies. In a study by Investor's Business Daily of the 600 biggest market winners from 1952 to 2001, three out of four posted earnings increases of more than 70% in the latest quarter before they launched terrific rallies.

This website grades stocks according to a range of criteria. Typically these are listed in a similar manner as shown below:

#### Company ABC Ratings

| Earnings Per Share (EPS) Rating | Relative Price Strength (RS) Rating | Industry Group Relative Price Strength Rating | Sales + Profit Margin + ROE Rating | Accumulation / Distribution Rating |
|---------------------------------|-------------------------------------|-----------------------------------------------|------------------------------------|------------------------------------|
| 61                              | 41                                  | B+                                            | A                                  | B                                  |

Explanation of terms:

EPS compares last two quarters and last 3-5 years of growth and stability with that of all other companies. A 90 rating means its earnings outperformed 90% of all other companies.

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Relative Strength measures a stock's relative price change in the last 12 months vs. all other stocks. The best companies rate 80 or more on both EPs and RS.

Industry Group Relative Price Strength Rating compares a stock's industry price performance in the last 6 months to 196 industries. Top industries rate A+, the worst rate E.

Sales + Profit Margin + ROE Rating combines recent sales growth, profit margins and return on equity into an A to E grade.

Accumulation / Distribution Rating measures buying vs. selling in last 13 weeks – A signals heavy buying

### **13.3.2      *Optionable Stocks***

It is vital that you trade stocks that are optionable. Not all stocks listed on exchanges are optionable. It is riskier to trade without options than with options. These optionable stocks will provide the foundation for your no or low risk consistently profitable trading strategy.

### **13.3.3      *Affordable Stocks***

It is not necessary to trade high priced stocks. Many stocks exist with good fundamentals, which are heavily traded and optionable at prices of \$20 or \$15 dollars or even \$10. If these companies can be identified then you have the advantage of allocating a set capital expenditure to that investment and still having the remaining portion of your portfolio available for other investments. Obviously higher priced stocks will deplete your trading funds more rapidly and hence will reduce your ability to spread risk among different stocks.

The reason you want to trade heavily traded stocks is the liquidity that results in reduced spreads (difference between Bid and Ask prices) as mentioned previously.

## **13.4    *Watch List***

When trading stocks it is advisable to create two watch lists. The first list contains stocks that you are actually trading at this point in time based on your research. The second inactive list contains stocks you are familiar with but are not currently trading. For instance they might meet fundamental criteria but your technical research does not indicate a trade entry is warranted or prudent. The technical research aspects will be covered later.

In your watch lists you should have a deep understanding of the fundamental, technical and sentimental aspects (covered later) of each of your stocks. As a result you will want to keep the number of stocks in your watch list to a manageable number.

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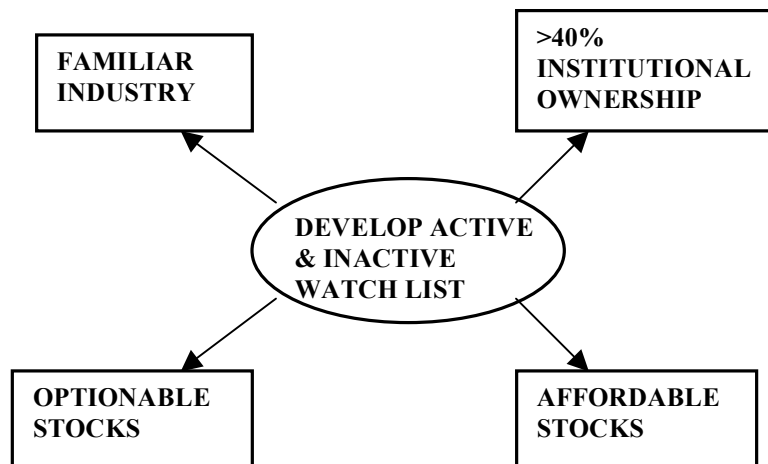
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### 13.5 Step 1

The first step in determining which stocks will form your portfolio is answering the following questions:

1. What industry/industries will be my primary source for stocks?
2. What price range am I comfortable trading stocks at? What capital do I have available? Am I comfortable trading higher priced stocks using more capital with less probability of large price swings and hence employs a more conservative trading strategy or am I looking to trade more affordable stocks and spread my risk across different stocks?
3. How many stocks do I believe I can comfortably trade at one time and still manage my portfolio?

### 13.6 Stock Selection Flow Diagram



### 13.7 Fundamental Analysis Summary

Understanding your stocks fundamentally and the overall market direction will enable you make better trading decisions with regards to strategy employed and defined exit points and will make you a better and more successful trader.

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Some stocks will be fundamentally excellent yet perform very poorly over certain periods of time. No stock goes straight up. The best stocks can fall and give up 10% to 20% or more of their market value on a whim. These occurrences of profit taking by institutions can sting individuals who think they can simply buy a top-rated stock at any time, then sit and wait for the profits to roll in. In order to correctly determine optimum buy and sell points you will also need to know how to correctly apply technical analysis tools.

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### *14.1 Introduction*

An important factor in determining your market trading success is the ability to correctly determine the expected direction and timing of a stock's movement. Technical analysis can help determine the timing of entry and exit points and provide insight into the imminent direction of a stock's movement. It provides insight into how investors view the stock currently.

Technical analysis tends to be most valuable in identifying profitable opportunities over shorter time frames. Fundamental indicators, on the other hand, tend to focus on the long term financial health of a company such as strong earnings growth. For this reason fundamental analysis is not sufficient as a stand alone tool for analyzing what stock to purchase and when to purchase it. Indeed, companies that show the strongest earnings growth can be worst performing stocks over short time frames. And conversely companies with poor earnings performance records can be stellar short-term performers. There are few fundamental indicators that are helpful for short term trading. However, indicators such as quarterly earnings announcements, management changes, product releases, take-over bids and so on tend to impact stock movement over the short term and so a combination of both technical and fundamental indicators is necessary in making decisions on what stock to buy and when to buy it. The third critical component in determining a stock or market's movement over the short term is investor expectation and the chapter on sentimental analysis will provide you with tools that, combined with your abilities to technically and fundamentally analyze stocks, will give you a significant advantage over your trading competition.

So, your fundamental analysis should determine what stocks will outperform the market over the long term. Your technical and sentimental analysis should dictate what the optimum market entry and exit points are, when to adopt a contrarian viewpoint and when to trade with the crowd.

Often you will see huge increase in the price of a stock prior to earnings announcements or based on a positive news release. And when the news finally reaches the public, the stock is very overbought and due for a correction. That correction can take the form of a slowdown in the current trend, stagnation in stock price or a pullback in price. The public will often be caught in the excitement of the news and react impulsively to jump on the bandwagon. They are motivated by both greed of further gains and fear of missing out on the next expected movement in stock price. This often leads to significant losses. This section will outline tools that can be used to determine situations in which a stock is overbought or oversold and hence due for a trend reversal or correction.

Technical analysis assumes the market is forward looking and discounts everything. As a result fundamental, political and economic events to name but a few are considered by the technical analyst to have been factored into the market. This provides a platform for predicting stock market behavior through analysis of price and volume of shares traded. Technical analysis also presumes the market moves in trends and early identification of

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these trends can lead to profitable opportunities. A further assumption of technical analysis is that market movements tend to repeat themselves.

Always pay close attention to the overall market trend in addition to the trend of your stock's industry. If the market moves in a direction opposite to that of your stock it can adversely affect the price of your options due to volatility changes.

### 14.2 Support & Resistance

So with this in mind we can look at some common terms used to make a determination on where a stock may trade in the future.

- **Support** is a value that a stock has difficulty crossing below. When the stock price hits this value it tends to bounce off it and trend up towards its resistance point.
- **Resistance** is a value that a stock has difficulty crossing above. When the stock price hits this value it tends to bounce off it and trend down towards its support point.



Figure 14.1 – Support & Resistance Lines

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### 14.3 Trends & Trading Ranges

A trend is identified when a line can be drawn between two points. The trend is not confirmed until the stock tests this initial line again and holds support or resistance thus creating a third point. The creation of the third point will validate the trend.

- **Uptrend** – An uptrend is defined as a series of higher highs and higher lows and is considered bullish

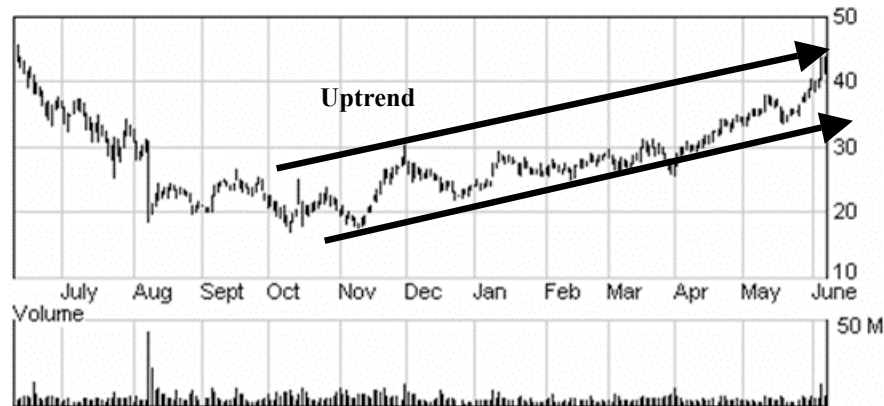


Figure 14.2 – Uptrend shown through higher highs and higher lows

The trend line provides a support area where bullish positions can be initiated. Within the uptrend you can then buy on the dips in stock price.

- **Downtrend** – A downtrend is defined as a series of lower lows and lower highs and is considered bearish

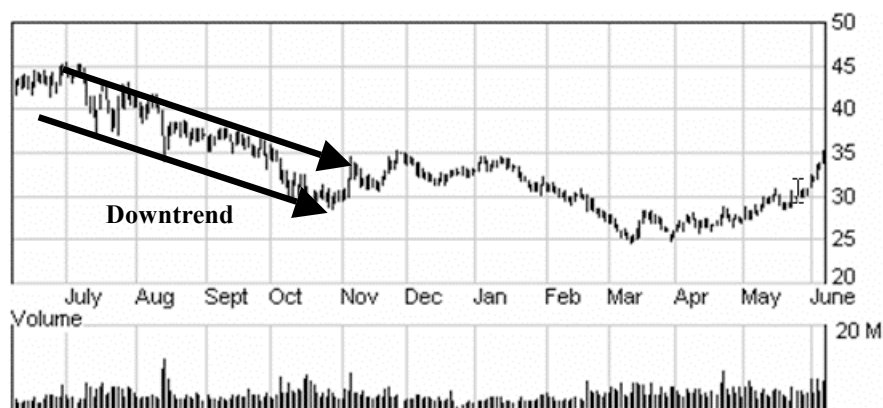


Figure 14.3 – Downtrend shown through lower lows and lower highs

You should generally trade with the trend. So in a downtrend it is recommended you initiate bearish strategies. It is a common pitfall to attempt to buy when the stock hits

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support in an attempt to pick a bottom. You should always let the market dictate the trend to you and trade accordingly.

These trends will signal optimum entry and exit points for your trades. You should be confident of the trend by observing the stock price continually bounce off support and resistance lines. If the stock price breaks through one of these points then it could signal the start of a new trend. So if the stock had been trending up but broke through the support line it could signal a trend change to either a stagnant trend or a downtrend. If the stock cannot close above the old support line having tested it a couple of times this line becomes the new resistance. Similarly in a downtrend if the stock closes above the resistance line it would signal a valid breaking point. If it remains above this point having tested it a couple of times this would instill confidence that the old support could act as new resistance.

- **Trading Range** – A trading range is observed when a stock trades between a previous high and a previous low. The stock will move up until it hits the upper end of the range and will then reverse direction until it hits the lower end of the range.



**Figure 14.4 – Trading Range**

If a stock price closes outside the trend line, this would constitute a valid breaking of a trend line. In general intra-day spikes above or below support or resistance points do not require strategy changes – unless you are a day trader of course. However these positions should be monitored closely as a trend change may be imminent.



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### 14.4. Price Gaps

Price gaps can occur in uptrends or downtrends on bar charts. Price gaps refer to areas on the chart where no trading occurs. In an uptrend this is due to prices opening above the highest price of the previous day. It results from huge demand for the stock.

A downtrend gap occurs when the highest price on a given day is below the lowest price of the previous day. Downtrend gaps are a sign of weakness in the stock and result from high supply.

Various types of gap exist including breakaway gaps, runaway gaps, exhaustion gaps and common gaps.

**Breakaway Gap** – A breakaway gap is almost invariably accompanied by huge volume. In the example below you can see that the gap coincided with huge volume of traded shares. It is often the result of a significant news event such as an earnings release, upgrades and downgrades. A breakaway gap can signal the beginning of a major move in a particular stock or market. Breakaway gaps are usually not filled, meaning the price does not reach the level it was before the gap occurred.



Figure 14.5 – Breakaway Gap

Stocks tend to trend in the direction of the gap for a period of time. When breakaway gaps occur a stock will tend to move with more momentum. This is seen in the example above where the gap was followed by a further significant decrease in stock price.

**Continuation Gap** – A continuation gap usually occurs around the middle of a significant move. The extent of the remaining move can often be estimated by measuring the distance from the original breakout and interpolating that a similar distance is likely before a trend reversal will occur.



**Figure 14.6 – Continuation gap**

Two other gaps that you should be aware of are mentioned below.

**Exhaustion Gap** – Exhaustion gaps occur near the end of a major move in the same direction as the previous move. The exhaustion gap tends to have little momentum and is often accompanied by low volumes. A combination of upward price movement and lower volumes after a previous uptrend is a big warning that the current trend may be about to reverse. In the case of the exhaustion gap, the stock price will fill the gap and the stock will likely trend in the opposite direction.

**Common Gap** – A common gap is a frequent event in which price returns to fill the gap within a few days of the gap appearing. A trend continuation in the direction of the gap does not occur. Volume tends not to be high relative to the previous trading days, which is a further indicator that the probability of the move resulting in a new trend is low.

### ***14.5 Moving Averages***

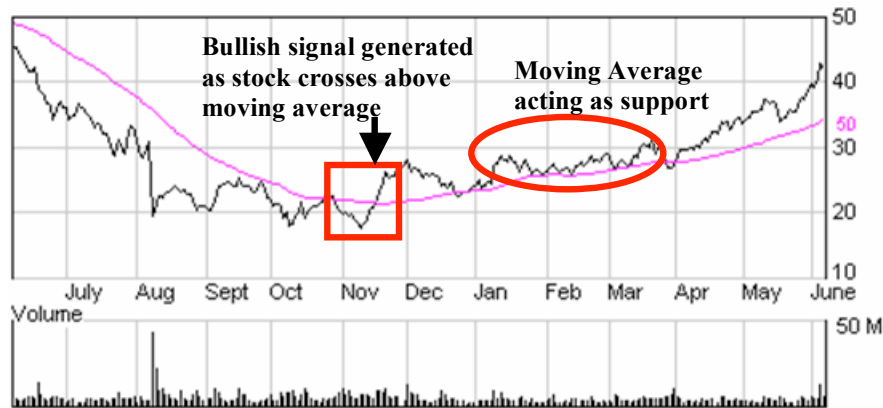
Moving averages are used extensively and should be well understood. Often when a tool or indicator such as a moving average is used very widely, it leads to self-fulfilling price movements. For example if everybody believes support exists at a commonly used moving average called the 200-day moving average then you will often see increased demand for the stock at this point that will cause the stock to reverse its downtrend and trend up towards its resistance.

A moving average is an average of a collection of data within a specific timeframe. For example a 200-day moving average of a stock price's closing data would consist of summing the last 200 days closing prices and dividing them by 200. The data that is averaged moves forward with each trading day.

A moving average is a lagging indicator. Leading indicators that forecast future prices will be covered later. Short time frame moving averages will tend to be close to price action. The moving average helps determine the onset of a new trend or the end of an old trend.

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In the chart below you can see that when the stock crosses above the 50-day moving average it tends to trend in the same direction and the moving average tends to act as a support for the stock. Prior to this, the moving average acted as resistance. The crossover that is highlighted by the box can therefore signal a trend change or in this case a buy signal.



**Figure 14.7 – Single Moving Average**

### ***14.5.1 Simple Vs. Exponential Moving Averages***

Simple moving averages give equal weight to each trading day's price action. So in the case of the 200-day moving average above, equal weight is given to the first day as the last day. This tends to be viewed negatively because the recent price action is of most interest.

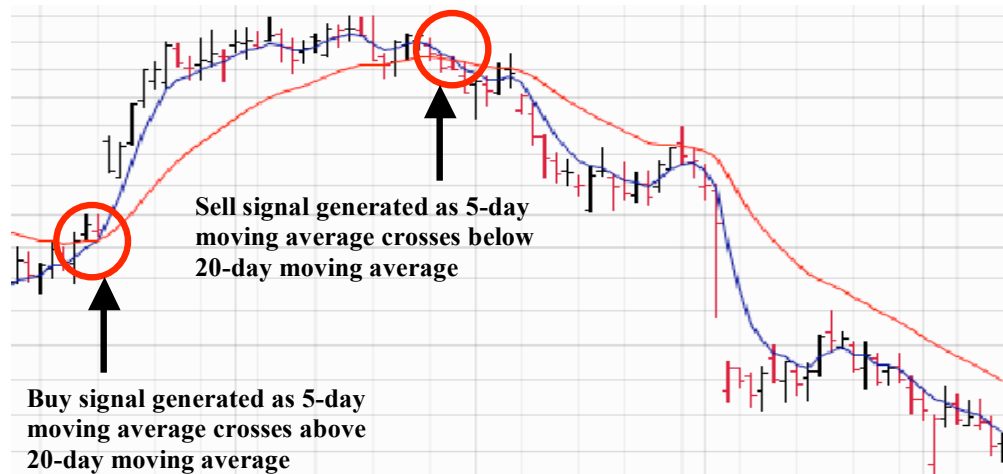
It is for this reason that it is strongly recommended that you use exponential moving averages. An exponential moving average gives greater weight to recent price action and is therefore a superior indicator for short term trends. Although not as much weight is assigned to the data as it becomes older, it still calculates all the existing data available.

### ***14.5.2 Combining Moving Averages***

Combining two moving averages to generate entry and exit points is a widely used technique that should be mastered. If you do not utilize any other technical trading tool, you should become adept at using and understanding this system. It is simple yet powerful. One shorter term moving average and one longer term moving average is used. A buy signal is generated when shorter term moving average crossed above the longer term moving average. Conversely, a sell signal is given when the shorter term moving average crosses below the longer term moving average. For longer term investors, a combination of 50-day and 200-day moving averages can be used and is a very popular combination. As mentioned previously the fact that buy and sell signals generated by 50-day and 200-day moving averages is so widely followed can be highly advantageous. It often becomes a self-fulfilling prophecy, meaning when the crossover occurs people will

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often buy or sell based on greed or fear that the crowd will also read the signals in a similar way and they don't want to miss the opportunity. For shorter term traders the 5-day and 20-day moving averages in addition to the 20-day and 50-day moving averages are popular combinations that are widely followed.



**Figure 14.8 – Moving Averages Combination**

### ***14.6 Bollinger Bands***

Bollinger bands were created by John Bollinger. They are constructed by placing two bands around a moving average and are placed two standard deviations above and below the moving average. Two standard deviations guarantees that 95% of the price data falls between the two bands.

If a stock rallies such that its price is outside the upper band, it is indicative of an overbought condition and is likely due for a pullback. Similarly if the stock price falls outside the lower band it is considered to be oversold. Often you can view upper and lower bands as lines of resistance or support and can hence use them as price targets. When the price bounces off the upper band it is likely to retreat to the average. The average can be considered as a support line, which, if broken, can subsequently act as resistance. In such a case the stock would likely continue down the lower band which would act as support. On the other hand if the stock bounced off the average it can be expected to head higher and return to the upper band.

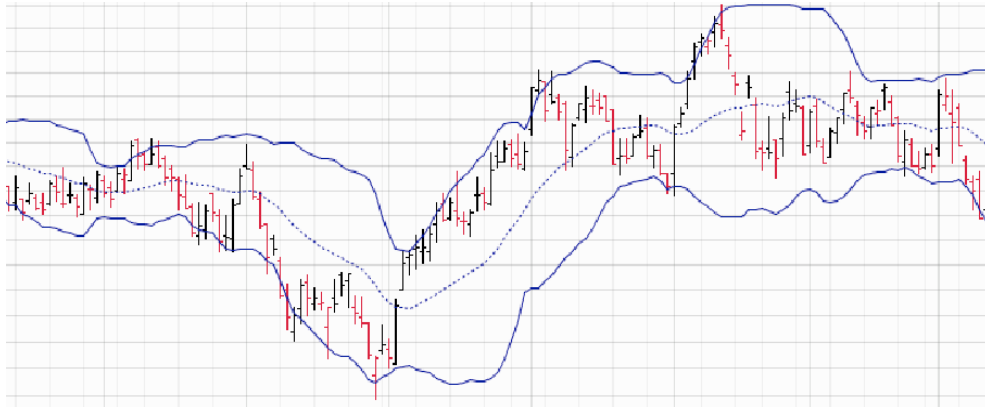
Typically a 20-day moving average is used. During an uptrend, price will usually fluctuate between the upper band and the 20-day moving average. If price penetrates the average, it is a clear warning sign of a trend reversal.

Bollinger bands work best when stocks are in a trading range and not trending. When the Bollinger bands contract it is usually indicative of decreased volatility and conversely

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when the bands are expanding it is a sign of increased volatility. A contraction can be a leading indicator of a breakout, particularly around earnings season.



**Figure 14.9 – Bollinger Bands**

The upper band is acting as a resistance level for the stock price while the lower band is acting as a support.

### ***14.7 Oscillators***

Technical oscillators measure stock price movement relative to the assumed cycles of highs and lows. Most oscillators have boundaries between 0 and 100. When price reaches each boundary it suggests the price has moved too far too fast. So, when the price reaches the extreme higher boundary, the stock is considered overbought and likely to correct. This would signal an exit point for a long bullish position. When the price reaches the extreme lower boundary, the stock is considered oversold. This would signal a time to be long the market. During strong trends, oscillators produce many false signals and are therefore most effective during non-trending stagnant markets or on stocks fluctuating in a trading range.

#### ***14.7.1 Relative Strength Index***

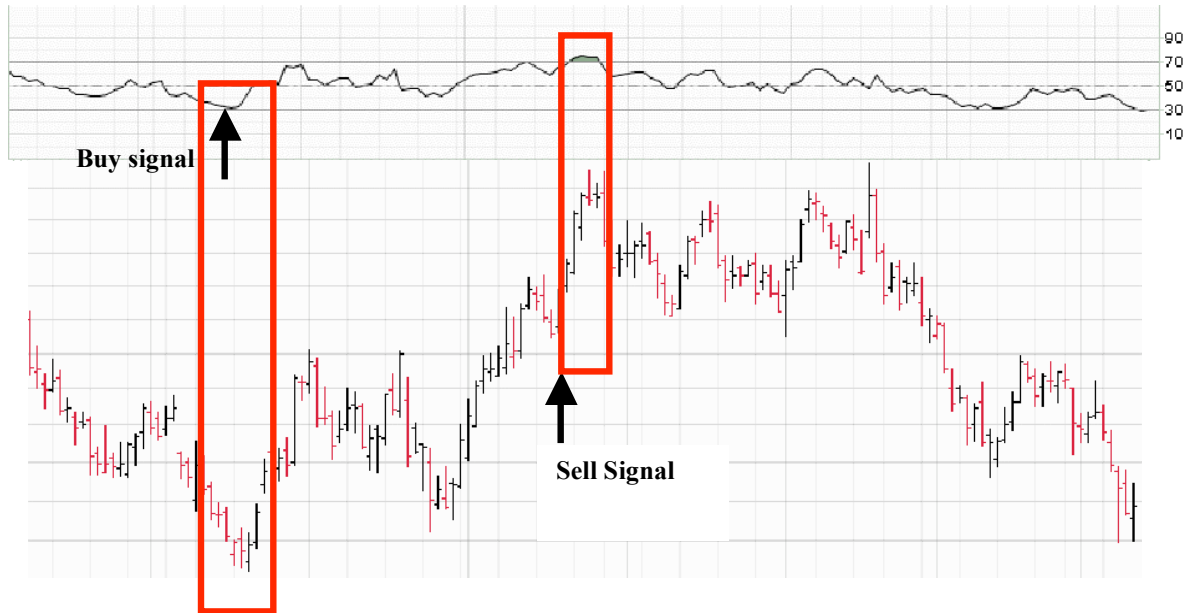
The relative strength index (RSI) oscillator is widely used to measure overbought and oversold conditions on a scale from 0 to 100 over a defined number of past trading days. The boundary conditions are usually considered to be as follows:

- **Overbought when value reaches extreme boundary of 70**
- **Oversold when value reaches extreme boundary of 30**

Generally you will not want to sell when the RSI indicates 70 or buy when the RSI indicates 30. The reason for this is that during strong uptrends the RSI can indicate an overbought stock for quite some time. Similarly during strong downtrends the RSI can indicate an oversold stock for quite some time. The best way to determine a market entry

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point is to identify when the RSI crosses back above the 30 boundary heading towards 100. Similarly the best way to identify an exit point is not when the RSI hits 70 and continues up towards 100 but rather when it crosses back below 70 trending back towards 0.



**Figure 14.10 – Relative Strength Index**

In the above chart you can see that the RSI has correctly identified entry and exit points for this particular stock. The optimum selling point occurred as the RSI fell below 70 and the optimum buying point was when the RSI rose above 30.

### **14.7.2      *Moving Average Convergence Divergence (MACD)***

The MACD, developed by Gerald Appel, is a leading indicator. This means it predicts a coming breakout in a stock that is above or below its key moving average. The MACD combines attractive features of oscillators with those of the moving average crossover system. It measures the difference between fast and slow exponential moving averages. The faster exponential moving average tends to be a 12 unit average while the slower exponential moving average tends to be a 26 unit average. A signal line is created by plotting a 9 period moving average over the line. When the signal line crosses above the MACD line a buy signal is generated. And when the signal line crosses below the MACD line a sell signal is generated.

Overbought conditions are also identified when the lines are too far above the zero line. Similarly oversold conditions are noted when the lines are too far below the zero line. A further way to identify entry points is when the price of a stock is trending down but the MACD lines are below zero and trending up. This is a leading indicator of an upward

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stock price movement. When the stock price makes a new high and the MACD lines are well above zero but fail to make a new high this is indicative of an imminent bearish trend.

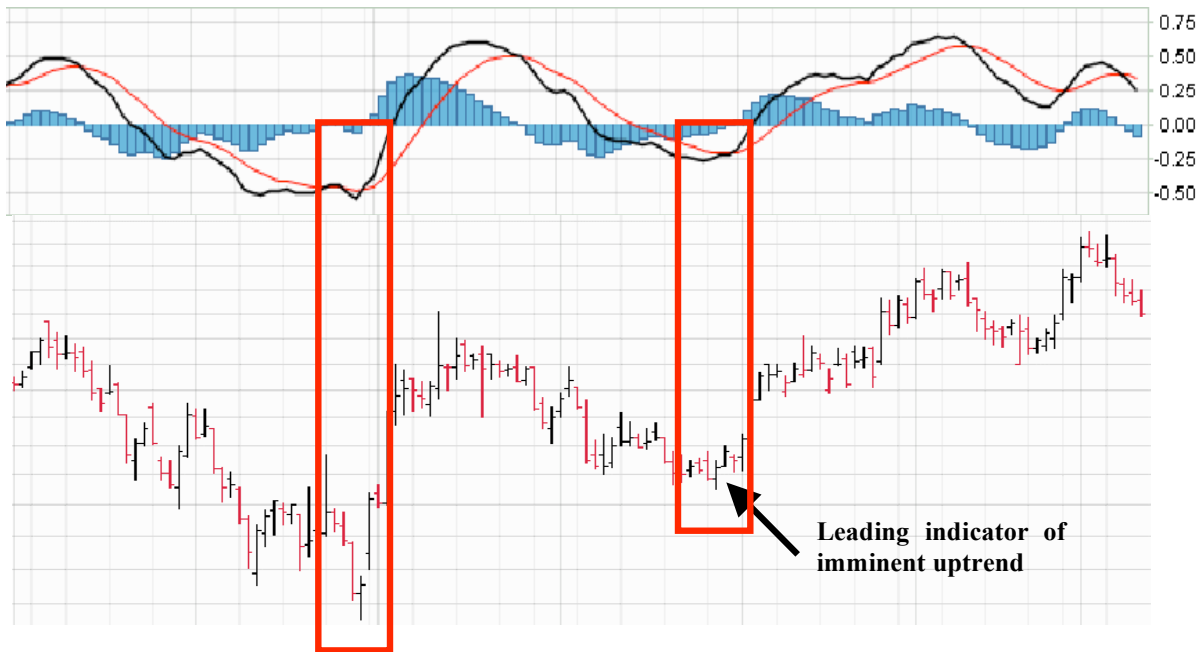


Figure 14.11 – MACD

The MACD is most effective during trending markets.

### 14.8 Online Stock Charting Services

A large number of online stock charting services are available free. These include

- [www.bigcharts.com](http://www.bigcharts.com)
- [www.stockcharts.com](http://www.stockcharts.com)
- [www.quicken.com](http://www.quicken.com)
- <http://finance.yahoo.com>
- <http://google.finance.com>

As an example, type “[www.bigcharts.com](http://www.bigcharts.com)” in the address bar of your browser. At the top of their home page you will see a link for “Interactive Charting”. Click this link. For the stock you are interested in charting, say IBM. Enter the ticker symbol (in this case “ibm” and alter the timeframe to 3 months to view the recent stock trend. Under the “Indicators” link you can apply technical tools such as moving averages, MACD, RSI and so on to the stock chart.

### ***14.9 Technical Analysis Summary***

Technical analysis is used to determine entry and exit points and thereby signals buy and sell opportunities. These buying and selling opportunities can be confirmed using combinations of indicators such as moving averages, MACD and RSI.

Technical analysis will increase your ability to correctly determine the expected direction and timing of a stock's movement. However, there are occasions when fundamental and technical analyses are not sufficient to correctly predict movement. Sometimes you will want to trade against the crowd and so you will need to understand sentimental analysis.



## CHAPTER 15 – SENTIMENTAL ANALYSIS

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### ***15.1 Introduction***

The majority of stocks will move in the same direction as the market so you must always have your finger on the pulse of major indices (S&P 500, NASDAQ, DJIA) to know how they are trending. Earnings releases, pre-announcements, annual meetings, economic indicators, upgrades, downgrades and news events are just some of the factors that can propel stocks to outperform the market or cause them to under-perform the market.

In general we will want to trade with the crowd. However the crowd tends to be wrong at both tops and bottoms so you will want to trade with the crowd during the trend but against them at both ends of the trend.

### ***15.2 How do I know when the market is at a top or bottom?***

Sentimental indicators gauge expectations of investors. This remains one of the least understood areas of market analysis and will provide you with an excellent reference for determining when the market has reached a bottom or a top. An explanation of the indicators listed below will be covered in this section.

- **VXO**
- **Put/Call Ratios**
- **Open Interest and Option Volume**
- **Short Interest**
- **“Book Cover Syndrome”**

#### ***15.2.1 VXO***

The longest and most consistent history relating volatility to equity market movements can be found in the S&P 100, or OEX, index and the associated volatility index, or VXO, developed by the Chicago Board Options Exchange.

The VXO is an excellent contrarian indicator. That means that when the VXO peaks exceptionally high the market is highly volatile and there is huge fear in the market which is usually followed by a market rally. One reason for this is that as selling increases to climactic levels, the supply of shares on the market decreases as the majority of bears have already unloaded their stock. In addition as the market drops to levels considered under-valued, so called “bottom-fishers” will step in to buy stocks and hence increase demand. When the VXO is between 15→35 the market is usually in a normal trading range, somewhere between complacency and fear. When the VXO goes above fifty it is a very strong indicator that the market is at or very close to a bottom and is a bullish indicator. Look at a chart of the VXO for the period between 1998-2002, each time the VXO went above 50 the market soon rallied bullish.

This indicator is not as reliable at identifying market tops. Since the market tends to climb a wall of worry but fall down a slope of hope, the volatility is lower as the market

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climbs higher. Thus it does not necessarily follow that because volatility is low and the market is stable then a collapse in prices is imminent. After all, it is the natural tendency of the market to increase over time. However, climactic selling at bottoms is not the natural course of the market and so contrarian indicators such as the VXO can be more effective in predicting trend changes at market bottoms than market tops.

### **15.2.2      *Put/Call Ratios***

Extremes in the ratio of trading volume in puts to the trading volume in calls can be an excellent indicator and predictor of an imminent trend change. Just as the volatility index will spike during periods of climactic selling or extreme bearish sentiment, the trading volume in puts will also spike as fear among traders intensifies. As mentioned above, the crowd is usually wrong at tops and bottoms. So, as contrarian investors, we view extreme pessimism in the market as an indicator that the market is on the verge of a rally or upward trend.

Similarly when complacency is prevalent in the market place, trading volume in calls far outnumbers trading volume in puts. At the peak of the “technology bubble” in March 2000, the put/call ratio dived as low as 0.13. This indicated an extremely bullish and complacent market place where expectation was very high that the market would continue to rise. The public believed their principal and profits were safe and in no danger of being lost due to a trend change to the downside. As a result few puts were bought to protect against the market collapse that subsequently occurred.

In general more calls are purchased than puts since the market tends to rise over the long term. So when the put/call ratio rises above 1.0 it indicates just as many puts are being purchased as calls and so fear is entering the market. As with the VXO, this indicator is most useful when extremes in sentiment are prevalent as a trend change is usually imminent.

### **15.2.3      *Open Interest and Option Volume***

Observing the cumulative demand in options can be a particularly helpful indicator in predicting future movements in stock direction. Open interest is the number of outstanding contracts on a particular option and so is a measure of this demand. Volume on the other hand is the number of option contracts that trade on a particular day or any time period.

An awareness of adjustments in open interest and option volume can help you in predicting short term movements of a stock. Inexperienced traders will often jump on the bandwagon of some widely published news stories and purchase cheaper out of the money options with the expectation of generating large gains once the stock moves in the direction predicted by the news stories. The cumulative effect of such a large number of option contract purchases at same or similar strike prices is a strong contrarian indicator. It is also in the interests of market makers to keep the options out of the money such that the stock doesn't trade in the range that would allow the option purchasers profit. So the

## CHAPTER 15 – SENTIMENTAL ANALYSIS

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strike price at which such a large number of option contracts are bought can act as resistance that the stock will find hard to penetrate.

When stocks rally strongly you will often find inexperienced traders attempt to pick the top by purchasing large quantities of put contracts. This is a bullish indicator to the contrarian as market tops are usually accompanied by high levels of greed in the market when traders purchase significant number of calls. Similarly as stock prices plummet, traders will attempt to pick a bottom by purchasing large quantities of calls. It is not until you see a large number of puts being purchased in a bearish trend or calls being purchased in a bullish trend that you could actually predict with confidence that a trend reversal is imminent.

The overall concept to take from this is that you should let the market dictate your trades. If it helps consider yourself in a boat floating down a stream, you should paddle such that you are moving in the same direction as the water flow at all times. Once you try to paddle upstream you will start losing ground. In the market you should not attempt to profit at the exact top and the exact bottom but rather ride the trend and, when the market confirms a change in trend, adjust your trades accordingly. If you attempt to predict direction changes there is a high probability that you will join the inexperienced traders that are always on the wrong side of the market and unnecessarily lose capital.

### **15.2.4      *Short Interest***

Short interest is the number of outstanding shares in a stock that have been shorted. This is a bearish move where traders are expecting to profit by selling a stock at the current price, purchasing the stock at a lower price and pocketing the difference. It is the reverse of the more conventional activity of buying a stock low and selling it high. This concept of selling a stock that you don't own and then buying it back is often difficult to grasp initially but it is nonetheless perfectly valid. This can be done with a margin account where your broker will deposit the funds in your account once you have sold the stock. The details of this strategy will not be covered here as it can be a highly risky strategy because if the stock moves up instead of down as predicted your risk is theoretically infinite (since theoretically there is no limit on how high the stock can rise).

How does knowledge of short interest help our trading decisions? Often at extremes in bearish sentiment people will short stock expecting to profit from further moves to the downside. As this short interest spikes to extreme levels it can be a predictive indicator of a trend change to the upside. Also as stocks rise and traders attempt to pick a top, the short interest can rise significantly. If the stock keeps rising, traders shorting stock will be at a loss and will be forced to buy back or cover their positions to minimize their loss. This increased demand will in turn result in higher stock prices.

So as short interest rises to peak levels be aware that in a down trending market a trend change may be imminent and in an up trending market the positive direction will likely continue.

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### 15.2.5 “Magazine Cover Syndrome”

The magazine cover syndrome is the condition where traders will buy into the fact that a stock has recently been highlighted by some publication that excites readers by listing the tremendous recent gains achieved by the stock. The mistake of buying into the publicity is often made by inexperienced traders. Often when a stock achieves widespread notoriety it is because it has surged up powerfully. However, when the publication finally hits the newsstands the demand is often almost exhausted as the big institutional investors have already made their bets. Often you will see the stock continue in the same direction for a short period before plummeting soon after.

Negative publicity can sometimes also indicate a bearish trend is near exhaustion. In early 2003 Cypress Semiconductor had fallen over an 8 month period by over 80% from its June 2002 level of approximately \$20. The stock bounced up from \$3.60 to about \$6 when an article appeared in a well-known publication encouraging traders to short the stock and buy it back at \$3. Within two months the stock had not halved in value but rather had risen 83% to \$11!

Beware of buying into such publicity and remember the publication you buy is simply trying to make money and often the more sensational the story the more likely it is to have higher circulation.

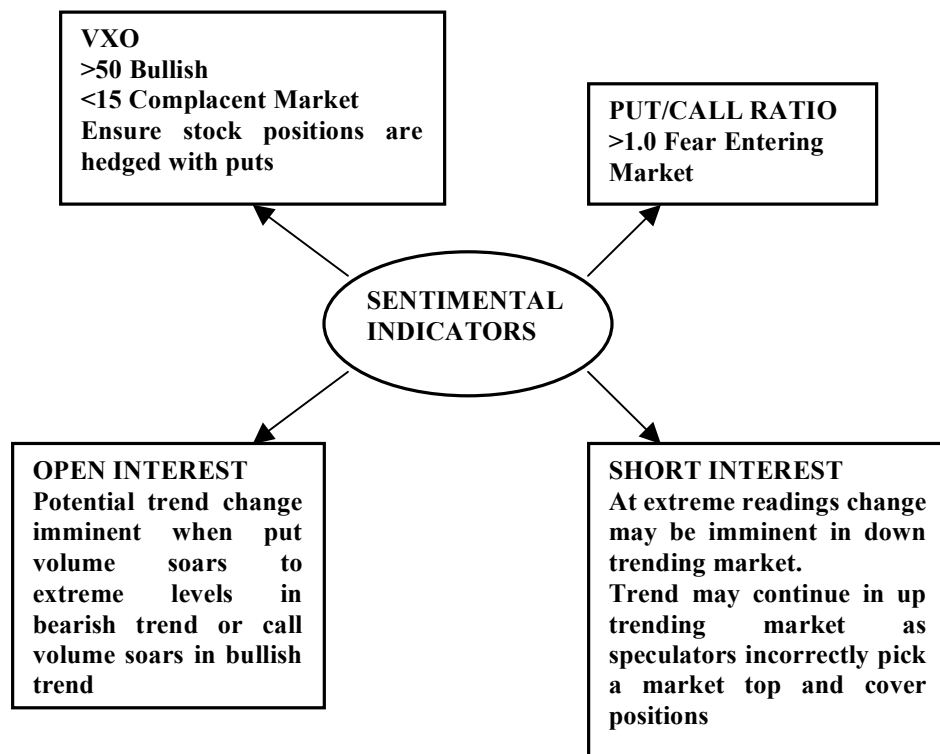
### 15.3 Where can I find sentimental indicators?

| Sentimental Indicator                    | Available At Website/Publication                                                                                                                                                                     |
|------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                          |                                                                                                                                                                                                      |
| <b>VXO</b>                               | <a href="http://www.bigcharts.com">www.bigcharts.com</a><br>Enter VXO in the “Enter symbol/keyword” box                                                                                              |
| <b>Put/Call Ratio</b>                    | <a href="http://www.schaeffersresearch.com">www.schaeffersresearch.com</a>                                                                                                                           |
| <b>Open Interest &amp; Option Volume</b> | <a href="http://www.cboe.com">www.cboe.com</a>                                                                                                                                                       |
| <b>Short Interest</b>                    | <a href="http://finance.yahoo.com">http://finance.yahoo.com</a><br>Enter stock symbol, for example MSFT for Microsoft. Click the “Profile” link and scroll down until you see short interest reading |

## CHAPTER 15 – SENTIMENTAL ANALYSIS

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### 15.4 Sentimental Indicator Flow Diagram



### 15.5 Sentimental Analysis Summary

The crowd tends to be wrong at the top and bottom of macro trends. Fundamental and technical analyses are not sufficient for accurately predicting these points in a trend. However, when combined with sentimental analysis you can confidently identify extremes in sentiment that will signal when to trade as a contrarian against the crowd.

The combination of these analysis tools with your due diligence will make you a better trader. But, if you want to trade like the professionals you will need to know how to trade options in such a way that you can profit irrespective of market conditions.

## **CHAPTER 16 – MONEY MANAGEMENT**

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### ***16.1 Introduction***

Smart money management and risk reduction principles should be central to your trading strategy. Investment decisions should be based on analysis and sound judgment, not emotion. A successful trading career will result from the elimination of greed and fear.

### ***16.2 Money Management***

In order to trade successfully, try not to become overly excited by gains or upset by losses. A very poor approach to trading is to invest money based on a gut feel or word of mouth. In both cases an absence of sound analysis leads to one hoping that the trade will be successful. Greed has likely cost more people more money in the market than fear. If a trade is executed based on a hope, it is inherently emotional and can lead to rash decisions that are based on poor judgment.

Often when a trade goes against an individual, they will find it very hard to cut their losses. They become emotionally attached to the trade, continuing to hope for a trend change. Many individuals continued to ride the stock market down from the peak in 2000 despite the fundamental, technical and sentimental indicators suggesting it would be prudent to cash out substantial gains.

You should set goals you wish to achieve and focus on what you need to do to achieve those goals. Set specific goals about what you wish to achieve within the next 3 months, 6 months and year. Afterwards you can set longer term goals. By writing down your goals you will attain a greater clarity about what it is that you really want to achieve. You will concentrate on furthering your knowledge, consolidating what you have learned and analyzing the facts prior to and following your trades. This will give you a huge advantage over the typical individual investor who invests based on emotion rather than fact. The process of making money will naturally follow.

When an individual concentrates on becoming the best in their profession, the money flows to them effortlessly. Similarly to be a successful trader, you should concentrate on trading correctly rather than focusing on the money. You should have clearly defined exit points to define the maximum potential risks and rewards that exist. Your approach should be systematic and structured. By this method you will be able to observe why your trades were profitable. By understanding your methodology for success you will have found the secret to continued successes because you will be able to repeat the process over and over and continue increasing your portfolio size and net worth.

### ***16.3 Capital Diversification***

In the Fundamental Analysis chapter you determined what stocks would optimize your trading approach. You determined what industry you should invest in, the price range for

## CHAPTER 16 – MONEY MANAGEMENT

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the stocks you would be trading, the capital you have available to trade, the price range of the stocks you will be trading and the number of stocks you will comfortably manage trading.

Many advisory services will suggest what trades to make and when to make them. They often say very little about what trading capital you should commit to a particular trade. Let's consider some examples to highlight the importance of diversifying your money across multiple trades.

Let's say you have \$10,000 in your account to trade. If you have an aggressive money management plan you may decide to place two trades, each of \$5,000. You are now risking your entire account on these two trades. If these two trades are collar trades and you have pre-defined exit points and are comfortable with the maximum risks involved and confident in your ability to adjust the trade then you can trade with assurance that you will make money or at the very aware of what your maximum loss is. On the other hand if you were to buy from month options which huge time decay and risk your account on these trades you could very quickly find yourself without capital reserves should the trades move in the wrong direction.

Keep in mind that if you make a loss you will need a greater percentage gain increase to return to parity.

| Percentage Loss | Percentage Gain Required To Recoup Loss |
|-----------------|-----------------------------------------|
| 10%             | 11%                                     |
| 20%             | 25%                                     |
| 30%             | 43%                                     |
| 40%             | 67%                                     |
| 50%             | 100%                                    |

A much more prudent approach would be to allocate 10% of your portfolio to each trade. If half your trades make a 50% loss and half make an 80% profit you will have made a 15% profit.

### ***16.4 The Rules Of Money Management***

The first rule of money management is to never trade money you cannot afford to lose. Trading with money necessary for daily expenses will adversely affect your judgment and your clarity of thought. Your trading will become emotional rather than based on sound analysis and facts.

The second rule of money management is to ensure that you spread your risks appropriately to ensure survival. When the market makes strong directional moves you need to have capital available to take advantage. If you have divided your entire trading capital between two trades you may quickly find yourself without means to capitalize on such market moves.

## CHAPTER 16 – MONEY MANAGEMENT

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The third rule of money management is to earn a steady rate of return. Your trading approach should target consistent profits. If you are consistently profiting in the market you will one day find all the small profits have turned into a mountain of profits.

The fourth rule of money management is to earn a high rate of return. An aggressive approach could form part of your trading strategy but should not be your primary trading strategy. Once you have learned how to consistently make money in the market at a steady rate you can attempt more aggressive strategies.

### ***16.5 Summary***

Good money management is considered by many to be the most important factor in becoming a successful trader. Choosing appropriate strategies that match your capital availability, risk tolerance and financial goals will provide a sound basis for an excellent money management plan.



## CHAPTER 17 – SELECTING A BROKER

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### ***17.1 Introduction***

If you have come this far you have obviously been become enthusiastic about the potential to profit consistently in the stock market through the strategies outlined. If you have not done so already, you will need to open an equity options account with a brokerage firm.

This section details some important issues to consider when choosing an options broker.

### ***17.2 Brokerage Considerations***

The criteria you use to select a brokerage firm should include the following factors:

- **Account & Margin Requirements**
- **Service & Features**
- **Commissions & Fees**
- **Options Expertise & Reputation**

#### ***17.2.1 Account & Margin Requirements***

Account and margin requirements will vary from broker to broker. Some brokerage firms will require minimum initial deposits of \$2,000 and some will require \$10,000 minimums.

The margin requirements for equity options trades will vary between individual brokerage firms. The maintenance margin requirements will also vary depending on the type of options strategy you employ. For example some brokerage firms will request you sign a form stating your level of options trading proficiency. If you have studied this course, thoroughly understood the strategies you intend employing and have successfully paper traded, you can confidently claim you are a proficient options trader. When granted margin privileges you can both buy and sell long and short calls/puts. The contract you sign is protection for the brokerage firm to ensure that individuals with margin privileges understand all the implications of the trades they place. For example a novice trader selling naked calls could rapidly run into trouble in bullish market conditions. If you have understood this course you would be far less inclined to place such trades as the risks are theoretically unlimited. This is one of the benefits of spread trading that you will always be aware of your maximum risks and maximum gains.

If you do not have the capital needed to meet the requirements for full margin privileges of your selected brokerage firm, you should still be able to purchase long puts and calls. Brokerage firms will usually require greater capital or higher options trading proficiency level for shorting puts and calls. If you are in this situation simply use the long puts and

## CHAPTER 17 – SELECTING A BROKER

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calls to build your portfolio until you can establish an equity options account with full margin privileges or consider a different brokerage firm.

When purchasing long puts or long calls, brokerage firms will require as a minimum that you can pay for the option premium in addition to the commission costs. Many brokerage firms will require a larger minimum equity in the account before initiating an options trade. So if you wanted to buy 1 ABC January 20 call at \$1.50 per share you would need \$150 + commission costs to enter the trade.

When shorting or selling puts, you will generally be required to maintain 50% of the underlying stock value – amount by which option is out of the money + premium received. For example if ABC stock is trading at \$20 per share and you want to short a November 15 put for a credit of \$1 per share, the margin requirements would be:

$$[(50\% \times \$20) - (\$20 - \$15) + \$1] \times 100 \text{ shares} = \$600$$

For credit spreads you must maintain the difference between the strike prices minus the credit received. For example if you did a bull put on ABC stock selling a March 20 put and buying a March 15 put for a credit of \$1 per share your margin requirement per contract would be:

$$[(\$20 - \$15) - \$1] \times 100 \text{ shares} = \$400$$

Margins are usually calculated after the market closes. If you have a position that has moved strongly against you, the brokerage firm may issue a “margin call” requiring you to deposit additional funds to maintain your position. If you are unable or unwilling to do so a part of your account will be liquidated to meet the call requirements.

### 17.2.2 Service & Features

The decision to choose a broker based on the service they provide will depend on your trading approach. If you require personal service and attention you will probably want a *full-service brokerage*. You will be assigned an individual broker who will personally handle your account. Minimum account requirements and commissions are generally higher for full-service brokerages than for discount firms.

If you prefer to be in charge of your own trades or do not have the capital needed to meet the requirements of a full-service brokerage you will probably want to choose a *discount broker*. These firms tend to have reduced fees and lower commissions compared to full-service brokers. Internet brokerages are an example of discount brokers and will allow you enter trades via the World Wide Web.

You should also consider what features are available and how they best fit with your trading style. If you expect to trade once a month or once a year, you will probably not be particularly interested in streaming real-time quotes. On the other hand if you expect

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to trade more frequently and be able to access real-time quotes at a moment's notice you will want your brokerage firm to provide that service either free of charge or for a minimal cost. If your brokerage firm does not provide real-time quotes free to you, you will generally be quoted prices with a 20-minute delay.

Many brokerage firms will claim fast execution speeds. You should be aware that these generally refer to filling stock orders. Option trades will often take a little longer. If you are exercising option contracts they will usually take place after the market closes on a given trading day.

You should also decide whether you want to have access to services such as bank wires, monthly statements and written or electronic confirmations.

### ***17.2.3 Commissions & Fees***

Commissions are paid when entering and exiting equity positions. They vary widely depending on brokerage firm. Often they can be modified depending on account activity and account size. Commission costs as a percentage will tend to decrease as the total dollar amount or the number of contracts being traded increases. Spread trades will generally be charged two commissions, one for each side of the trade.

When entering credit trades your primary exit point will often be to let the options expire worthless. In the event that an option expires worthless, only entry commissions are paid.

When choosing your brokerage firm you should be aware of what fees they charge. Ask them if they have penalty charges for not maintaining minimum equity balances or for withdrawing funds.

### ***17.2.4 Options Expertise & Reputation***

The level of options expertise is a critical factor in deciding what brokerage firm to choose. Your brokerage firm should fully understand options trading and have support staff that can handle difficult or complex options transactions and fully understand the risks and rewards associated with the strategies you employ. Options specialized brokerage firms have grown in recent years serving the special needs of options traders.

Try to ascertain if your broker has an established reputation for executing trades promptly and going the extra mile for its customers. These characteristics will enhance your trading experience and can often lay the groundwork for negotiating reduced commission costs or adding greater flexibility to your trading when you have established a good relationship.

## CHAPTER 17 – SELECTING A BROKER

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### *17.3 List Of Brokers*

A list of brokers that have a good understanding of spread trading is listed below. No recommendations are being made by providing this list nor is the list in any order.

| Brokerage Firm | Website Address                                                         |
|----------------|-------------------------------------------------------------------------|
|                |                                                                         |
| OptionsXpress  | <a href="http://www.optionsxpress.com">http://www.optionsxpress.com</a> |
| ThinkorSwim    | <a href="http://www.thinkorswim.com">http://www.thinkorswim.com</a>     |
| Charles Schwab | <a href="http://www.schwab.com">http://www.schwab.com</a>               |
| Ameritrade     | <a href="http://www.ameritrade.com">http://www.ameritrade.com</a>       |
| Accutrade      | <a href="http://www.accutrade.com">http://www.accutrade.com</a>         |
| Trade Station  | <a href="http://www.tradestation.com">http://www.tradestation.com</a>   |
| Scottrade      | <a href="http://www.scottrade.com">http://www.scottrade.com</a>         |
| E*Trade        | <a href="http://www.etrade.com">http://www.etrade.com</a>               |

This is just a sample of brokerage firms that provide an options trading service. Many are based in the United States yet they will still accept international accounts, e.g. OptionsXpress.

### *17.4 Summary*

Selecting the right broker to meet your personal needs is a very important step in trading options effectively. In this chapter you have learned some of the important factors to consider when choosing a brokerage firm that is right for you. Your process for selecting a brokerage firm should involve gathering information on several firms, determining what your needs are and what brokerage firm best meets those needs.

## APPENDIX A – STOCK MARKET ESSENTIALS

### Appendix A Stock Market Essentials

A brief overview of some important terminology is provided below:

| <b>Terminology</b>    | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Stock Exchange</b> | Association or body of brokers who are engaged in the business of buying and selling stocks, options and commodity futures                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Broker</b>         | An individual or firm that acts as an intermediary between a buyer and seller, usually charging a commission.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| <b>Stockbroker</b>    | Broker who deals primarily with transactions involving stock                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Trader</b>         | One who buys and sells securities for his/her personal account, not on behalf of clients                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <b>Market Maker</b>   | A brokerage or bank that maintains a firm bid and ask price in a given security (e.g. stock, option, bond) by standing ready, willing and able to buy or sell at publicly quoted prices (called making a market). These firms display bid and ask prices for specific numbers of specific securities, and if these prices are met, they will immediately buy for or sell from their own accounts. Market makers are very important for maintaining liquidity and efficiency for the particular securities that they make markets in.                                                                |
| <b>Stock Price</b>    | Agreed upon price by a buyer and seller of stock. Stock prices are quoted on per share basis and are quoted with both bid and ask price.                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <b>Bid Price</b>      | The price one receives for selling a stock or option. When demand exceeds supply, buyers are willing to raise their purchase or bid price.                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Ask Price</b>      | The price at which one buys a stock or option. When supply exceeds demand, sellers have to lower their sale or ask price.                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Slippage</b>       | The amount one loses between the bid and the ask prices. The market maker profits from the difference between the two prices for creating liquidity in the market.                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Order</b>          | A request from a client to a broker to buy (buy order) or sell (sell order) a specified amount of a particular security at a specific price.                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Market Order</b>   | A buy or sell order in which the broker is to execute the order at the best price currently available. These are often the lowest commission trades because they require very little work by the broker. The price at which the order is filled cannot be guaranteed and may vary from the figure quoted on the computer screen.                                                                                                                                                                                                                                                                    |
| <b>Limit Order</b>    | An order to a broker to buy a specified quantity of a security at or below a specified price, or to sell it at or above a specified price. This ensures that a person will never pay more than whatever price is set as his/her limit. This is one of the two most common types of order, the other being the market order. Limit orders guarantee the price at which the orders are filled provided the security reaches the price set. If the price is not reached the order may never be filled however it does allow the trader/investor control over what price the trade is entered or exited |
| <b>Stop Order</b>     | A stop order is a market order to buy or sell a certain quantity of a certain security if a specified price is reached or passed. A stop order does not                                                                                                                                                                                                                                                                                                                                                                                                                                             |

## APPENDIX A – STOCK MARKET ESSENTIALS

|                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                 | guarantee you will get filled at the exact stop order price because once the price is reached it becomes a market order                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>Stop Limit Order</b>         | An order to buy or sell a certain quantity of a certain security at a specified price or better, but only after a specified price has been reached. It is essentially a combination of a stop order and a limit order.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>GTC (Good-Till-Canceled)</b> | An order to buy or sell which remains in effect until it is either executed or canceled. Brokers usually set limits of 30 or 60 days after which the order is automatically canceled.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Day Order</b>                | A buy or sell order which automatically expires if it is not executed during that trading session.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Fill-Or-Kill</b>             | An order given to a broker that must be filled in its entirety or, if this is not possible, canceled.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>All-Or-None</b>              | A stipulation of a buy or sell order which instructs the broker to either fill the whole order or don't fill it at all; but in the latter case, don't cancel it, as the broker would if the order were a fill-or-kill.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>Long</b>                     | When a stock or option is owned, one is said to be long the stock or option e.g. Joe Trader is long 100 shares of ABC stock means Joe Trader owns 100 shares of ABC stock.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Short</b>                    | <p>Borrowing a security from a broker and selling it with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker. Short selling is a technique used by investors who try to profit from the falling price of a stock. For example, consider an investor who wants to sell short 100 shares of a company, believing it is overpriced and will fall. The investor's broker will borrow the shares from someone who owns them with the promise that the investor will return them later. The investor immediately sells the borrowed shares at the current market price. If the price of the shares drops, he/she "covers the short position" by buying back the shares, and his/her broker returns them to the lender. The profit is the difference between the price at which the stock was sold and the cost to buy it back, minus commissions and expenses for borrowing the stock. But if the price of the shares increases the potential losses are unlimited. The company's shares may go up and up but at some point the investor has to replace the 100 shares that he/she sold. In that case, the losses can mount without limit until the short position is covered. For this reason short selling is considered very risky.</p> <p>e.g. Jack Trader is short 100 shares of XYZ stock. This means Jack Trader has borrowed stock XYZ from a broker and sold it with the understanding that it must later be bought back.</p> |